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IN THE

Supreme Court of the United States

OCTOBER TERM 1979

No. 79-828

EDWARDS AND HANLY,

Petitioner,

against

WELLS FARGO SECURITIES CLEARANCE CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

Opinions Below

The opinion of the United States District Court for the Southern District of New York (A., pp. 32a-72a) is reported at 458 F. Supp. 1110 (S.D.N.Y. 1978). The opinion of the United States Court of Appeals for the Second Circuit (A., pp. 1a-27a) is reported at 602 F.2d 478 (2d Cir. 1979).

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit sought to be reviewed (A., pp. 28a-29a) was entered on June 27, 1979. A motion for rehearing and a suggestion for a rehearing *en banc* was thereafter filed and the orders denying a rehearing and rejecting the suggestion of a rehearing *en banc* were entered on August 23, 1979 (A., pp. 30a-31a). The instant petition is filed within 90 days of the order denying rehearing and rejecting the suggestion of a rehearing *en banc* and is thus timely pursuant to 28 U.S.C. § 2101(c).

Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented for Review

1. Whether a broker's obligation under Regulation T of the Federal Reserve Board, 12 C.F.R. § 220, to buy in securities for a defaulting customer's account and risk, is defined solely by objective standards or whether the requirement contained in that Regulation that a broker have a good faith belief that the securities sold were sold long and would be delivered may be defined by the subjective circumstances surrounding the broker's course of dealings with each customer, the custom and usages of the brokerage business and the reasonableness of the broker's reliance upon activities of persons perpetrating a securities fraud.

2. Whether a broker's alleged violations of Regulation T or its alleged negligence in failing to buy in securities for the account of a defaulting customer may operate as a complete bar to a broker's recovery against a violator of the anti-fraud provisions of the Federal Securities Laws.

3. Whether the United States Court of Appeals for the Second Circuit exceeded its statutory authority by engaging in extensive *de novo* appellate fact finding in contravention of Rule 52(a) of the Federal Rules of Civil Procedure including the finding of facts not contained in the record, and by the substitution of its own concept of the manner in which the brokerage business is conducted for the concept explained to and accepted by the Court below.

Statutes and Regulations Involved

The following statutes and regulations are set forth in the appendix:

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g.

Section 10(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(a).

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

Regulation T of the Federal Reserve Board, 12 C.F.R. § 220.4(a) and (c).

Regulation X of the Federal Reserve Board, 12 C.F.R. § 224.2(a) and § 224.6.

Rule 10a-1(d) under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10a-1(d).

Rule 10a-2(a) under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10a-2(a).

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5.

Rule 52(a) of the Federal Rules of Civil Procedure.

Statement of the Case

Petitioner Edwards & Hanly (E&H) sought in excess of $1.4 million in damages from Respondent Wells Fargo Securities Clearance Corporation (WFSCC) in the United States District Court for the Southern District of New York alleging that WFSCC had violated among other laws, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and had committed a common law fraud in connection with its activities as clearing agent for T. P. Richardson & Co., Inc. (Richardson) a California third-market broker. Jurisdiction of the District Court was invoked, among other grounds under 15 U.S.C. § 78aa and the principles of pendent jurisdiction. It was undisputed that Richardson, whose business was to match buy and sell orders of large blocks of listed stock made by large financial institutions, had deviated from its regular practice of matching buy and sell orders on institutional trades and had engaged in a massive short selling scheme for its own account in highly volatile "glamour" stocks. E&H, which had a long standing relationship with Richardson, was one of the broker-dealers used by Richardson to facilitate its massive short selling. Between approximately March 3, 1975 and April 7, 1975, Richardson, which maintained a cash account with E&H, sold approximately $7 million worth of stock through petitioner. On April 15, 1975, Richardson advised the Securities and Exchange Commission that it was insolvent and broker-dealers including the petitioner, were required to buy in over $20 million worth of short sales to cover the stock sold by Richardson which had not been delivered. E&H suffered a loss of $1,441,122.45 which was the difference between the price of the securities sold by Richardson which were not delivered and the price at which these securities were bought in by E&H for Richardson's account and risk.

Following a non-jury trial, the United States District Court for the Southern District of New York found that WFSCC had violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 by aiding and abetting Richardson in its short selling scheme and in hiding that scheme from, among others, the brokers through whom the short sales were improperly effected. The comprehensive opinion of the District Court, 458 F.Supp. 1110 (S.D.N.Y. 1978) (A., pp. 32a-72a) recited that WFSCC had materially assisted Richardson in the perpetration of its fraud by virtue of the acts of the President of WFSCC, Joseph C. Werba (Werba), which deviated from the normal business relationship between Richardson and WFSCC, as its clearing agent.

These deviations included: (1) unauthorized direct contacts between WFSCC and Richardson concerning trades to be cleared through Wells Fargo Bank, an affiliated company to WFSCC with which Richardson maintained a draft line of credit; (2) unauthorized advancement of unsecured monies by WFSCC to Richardson to facilitate the short selling scheme using a float created in the WFSCC bank account with the Morgan Guaranty Trust Company; (3) institution of so-called "special trades" (trades effected directly with WFSCC, and without the knowledge of Wells Fargo Bank) and (4) giving of monies to WFSCC personnel by Richardson including Werba as gratuities for assisting Richardson in its improper activities. These deviations were not contested by WFSCC.

The District Court also found that Werba had been advised by Richardson that Richardson was engaged in short selling (A., pp. 40a-41a), that Werba had been given $2,000 by Richardson "for helping them out" (A., p. 41a) and that Werba although knowing that Richardson maintained cash accounts with broker-dealers had insulated himself from the day-to-day operations of WFSCC including calls by

the broker-dealers to the clearing corporation inquiring after the delivery of stock when Richardson failed to deliver massive amounts of stock (A., p. 42a).

Accordingly, the District Court ruled that since Werba knew that the reason Richardson wished to institute the so-called "special trades" was its massive short selling position and since Werba either knew or recklessly failed to discover that Richardson was defrauding broker-dealers by failing to disclose its short position, that Werba, and thus WFSCC had aided and abetted Richardson in its short selling scheme.

The District Court also rejected several affirmative defenses raised by WFSCC including that E&H had violated Regulation T of the Federal Reserve Board in connection with its dealings with Richardson. The District Court specifically found that the pattern of trading in the Richardson account, and more particularly lateness in making deliveries, was not so unusual as to charge E&H with a lack of diligence in discovering the fraud or to provide the basis for a finding that E&H lacked a good faith belief that the securities would ultimately be delivered into the account (A., pp. 67a-68a). The District Court specifically found that delays of over three weeks were customarily tolerated in the industry, that only a small percentage of the Richardson sale orders which ultimately failed were over 3 weeks late and that Richardson in fact delivered a large block of stock to E&H as late as April 7, 1975, just one week prior to its collapse, and had made other deliveries during the critical period (A., pp. 63a-64a, 67a-68a). The District Court further found that E&H's "good faith" belief that the stock would be delivered was to be judged by the totality of circumstances and that the particular circumstances in the instant case, to wit; the usual practice in the industry of allowing brokers more time to effect deliveries than was accorded retail customers, the long standing relationship between E&H and Richardson

and a prior pattern in November and December 1974 in which the stocks had been delivered late and the inquiries made by E&H in late March and early April 1975, did not amount to conduct which precluded the finding of a good-faith belief that the stock would be delivered (A., pp. 67a-68a). Accordingly, the District Court awarded E&H judgment in the sum of $1,441,122.45, together with interest.

On June 27, 1979, the United States Court of Appeals for the Second Circuit entered a judgment reversing the judgment of the District Court and ordering a dismissal of the complaint. The Court of Appeals concluded that Werba's activities in lending Richardson money free of interest to finance completed sales and in hiding the special trades (which were all completed trades) from the bank did not substantially assist the violation of Rule 10b-5 by Richardson which was not the short selling but the failure by Richardson to tell E&H that it was selling short (A., p. 12a). The Court of Appeals further held that such activities were not the proximate cause of E&H's loss (A., p. 12a). Thus, the Court of Appeals found that unless Werba knew that Richardson was defrauding broker-dealers by failing to disclose its short position, no liability could attach to WFSCC for Werba's clearly illegal acts which unquestionably substantially assisted Richardson in the financing and hiding of its short selling scheme (A., pp. 9a-12a). While these conclusions may well be erroneous, in view of the Court of Appeals' disposition of the appeal on other grounds it is not believed that review of these legal conclusions is appropriate at the present time.

The Court of Appeals ruled, however, that E&H was barred from recovering because the proximate cause of its loss was its own negligence and because E&H had violated Regulation T in its dealings with Richardson (A., pp. 16a-18a). The Court ruled that it was not bound by the "clearly erroneous" test mandated by Rule 52(a) of the Federal Rules of Civil Procedure in reaching

factual conclusions directly opposite to those reached by the District Court (A., p. 16a).

The Court of Appeals held that the tolerance by the industry of deliveries after the statutory 5-day period and, more particularly, the tolerance as an industry standard of 3 week delays in delivery from third market brokers constituted a violation of Regulation T (A., p. 18a). The Court further held that E&H failed to exercise due diligence as a matter of law by not realizing that the late deliveries indicated short selling by Richardson, by failing to seek or obtain satisfactory explanations for the delay in delivery from Richardson and by failing to buy in the account within a reasonable time (A., pp. 18a-19a). The Court rejected the "totality of circumstances" test for a violation of Regulation T propounded by the District Court and more particularly rejected E&H's position that partial deliveries, the tolerance in the industry of 3 week delays in delivery, the assurances in fact received from Richardson and the inquiries made of WFSCC constituted a fulfillment of E&H's obligations under Regulation T and negated any defense that E&H failed to exercise due diligence.

The Court of Appeals, by ruling that the proximate cause of the injury to E&H was its own negligence and its violation of Regulation T ruled by implication that negligence, or lack of due diligence, or a violation of Regulation T could be defenses to a cause of action in securities fraud. Moreover, the Court of Appeals, as will be more fully explained below, rested its decision upon findings of fact that not only were not contained in the record below, but were probably erroneous as well. A petition for rehearing and suggestion for rehearing *en banc* resulted in the Court of Appeals correcting its opinion, in October 1979, so as to delete one egregiously erroneous finding of fact (A., p. 27), although as will be shown below, the legal conclusion based upon that finding was not deleted from the

opinion. In any event, the petition for rehearing and the suggestion for rehearing *en banc* was denied on August 28, 1979.

REASONS FOR GRANTING THE WRIT

This Court has never ruled upon the standards imposed upon broker-dealers for complying with Regulation T of the Federal Reserve Board. The decision of the Court of Appeals in denying a victim of securities fraud compensation for its damages because of the victim's alleged violation of that regulation and the effect which the ruling of the Court of Appeals may have upon the effective operation of the securities markets makes it apparent that these standards should be settled by this Court.

Prior to the decision of the Court of Appeals in the instant case, the leading case involving a broker's obligations under Regulation T was *Naftalin & Co.* v. *Merrill Lynch Pierce Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972). *Naftalin* established that the duties of a broker executing sale orders for a customer in a cash account are comprised of two independent obligations:

(1) They require that the broker-dealer have a good faith belief at the time he executes a "sell" order for a cash account that the order is "long", i.e., that the customer in fact owns the securities and that the securities will be promptly delivered, 469 F.2d at 1175; and;

(2) These rules and regulations impose a continuing obligation of good faith on the broker-dealer creditor, i.e., he must make continuing efforts to secure delivery of the securities from the customer, and, if they are not delivered, he must "buy in" the account, 469 F.2d at 1176.

Naftalin specifically ruled that the continuing obligation of good faith on the part of the broker-dealer is meas-

ured by the facts of the individual case. The Court noted:

> "The rejection of a specific delivery date requirement does not, however, mean that Regulation T may be read as sanctioning unnecessary or avoidable delays. Section 4(c)(1)(ii) places determinative emphasis upon the broker/dealer's good faith, and in the absence of an absolute liquidation requirement we must focus on that good faith as the test of compliance. The good faith of a broker/dealer who has originally executed a sell order in compliance with Regulation T must gradually dissipate as time passes without delivery of the securities. The time comes when the good faith standard of section 4(c)(1)(ii) requires the broker/dealer to make inquiry concerning the reason for delay and to act accordingly. If, upon inquiry, the broker/dealer ascertains that the slow delivery is unavoidable and out of his customer's control, he may indulge a reasonable delay commensurate with the circumstances without any impairment of good faith. If no credible explanation for the delay is forthcoming, the transaction must be bought-in immediately.
>
> The difficult task, of course, is to determine the point in time at which the broker/dealer must take some affirmative action. Because of the flexibility intended for the post-1939 version of Regulation T, we think the fixing of that point must depend in each case upon an analysis of the normal practice and expectations as to delivery existing in the market at the time of the transaction, taking into consideration the actual status and business relationship of the parties involved." 469 F.2d at 1177-1178.

Naftalin went on to find that the usual practice in the industry is to allow broker-dealers more time in delivering securities than is accorded to other customers, 469 F.2d at 1178. The Court further recognized that the decision of what constitutes prompt delivery in the context of the facts

presented to it involved what is essentially a factual analysis and therefore remanded the case to the District Court to make that analysis.

In the instant case, however, the Court of Appeals determined E&H's obligation under Regulation T as a matter of law. The Court of Appeals explicitly rejected the factual findings of the District Court as to the long-standing business relationship between E&H and Richardson, the pattern of late deliveries in the past, the inquiries which were in fact made during the critical period and the deceptive making of partial deliveries timed to allay E&H's suspicions. Instead, the Court of Appeals laid down a test for compliance with Regulation T which goes far beyond the custom and usage in the brokerage business. For example:

(1) The Court of Appeals held that E&H had violated Regulation T because it did not, with respect to each and every trade executed by Richardson, inquire of Richardson as to whether each and every such trade was long or short. The ruling ignores the facts that Richardson and E&H or its predecessor firms operating the office involved had maintained a cash account on a third market basis for Richardson since prior to February 1974 and the account had a prior history of delivery of stock with delays of three weeks which was not uncommon.

(2) The Court of Appeals further held that E&H violated Regulation T by not demanding of Richardson, as to each and every transaction, a specific reason for each and every delay. Again, this ruling ignores the third market broker status of Richardson and the fact that in the brokerage business delays of this magnitude, as found by the District Court, are not uncommon. Moreover, in response to certain inquiries made by E&H, partial deliveries were, in fact, effected (see A., p. 102a) another fact which the Court of Appeals ignored in construing E&H's obligations under Regulation T.

(3) The Court of Appeals ruled that E&H violated Regulation T in borrowing stock to deliver it to its customers to cover Richardson's open positions. Although a specific factual finding to that effect was originally contained in the opinion, the opinion was subsequently corrected in October 1979 to delete the specific factual finding (A., p. 27a) although the legal conclusions that E&H had engaged in this conduct remained in the opinion (A., pp. 23a-24a). In fact, there was no evidence whatever in the record to support the conclusion that E&H had borrowed stock and in fact E&H did not do so. Moreover, the ruling by the Court of Appeals that the borrowing of stock is a violation of Regulation T is again contrary to the practices of the industry especially since most brokerage firms do not borrow stock to cover open positions.

(4) The Court of Appeals also ruled that E&H also violated Regulation T by inquiring of WFSCC as to when stock would be delivered. The Court of Appeals likened that inquiry to "asking a bank when a depositor would deposit a check or . . . asking a librarian when a borrower would return a book" (A., pp. 23a-24a). In fact, inquiries are frequently made to clearing agents as to whether they have stock to deliver or have instructions in house. The nature of the relationship between Richardson and WFSCC that WFSCC would only process "matched" trades for Richardson, a relationship known in the Street, made these inquiries even more appropriate.

Based upon the foregoing, it is respectfully submitted that the Court of Appeals' construction of Regulation T fails to take into account the relevant factors outlined by the 8th Circuit in *Naftalin,* fails to give proper weight to trade business and practices and imposes standards upon brokers and dealers in dealing with other brokers and dealers which are far too stringent and which would clearly inhibit the proper functioning of that aspect of the securities markets. It is possible that extensive dealings in large institutional blocks may be impeded if the standards imposed by the Second Circuit are allowed to stand. It is, therefore, essential that this Court determine the appropriate standards required by Regulation T in order to avoid these serious adverse consequences and to provide guidance to broker-dealers as to their obligations in the future.

The Court of Appeals, in the context of ruling that E&H's own negligence or violation of Regulation T was the proximate cause of its damage, has ruled that negligence or a violation of Regulation T can be defenses to an action in securities fraud, is a ruling in conflict with decisions of other Courts of Appeals or is based upon an unsettled legal principle.

The Court of Appeals ruled that E&H's failure to buy in the Richardson account resulted from E&H's failure to exercise due diligence in discovering Richardson's fraud and in doing something about it. The Court ruled that this failure to act was the effective cause of E&H's loss, rather than anything that WFSCC did.

Initially, it should be noted that the Court of Appeals, in ruling that E&H had failed to exercise due diligence and had violated Regulation T ignored the testimony of one of WFSCC's own expert witnesses, Mr. Francis Monigan that a number of factors would have to be considered in making the business judgment of whether to tolerate the risk including: (1) the fact that the account had a four or five year history during which late deliveries had been tolerated before the risk to the firm became substantial; (2) whether partial deliveries of stock had been made while the risk was outstanding; and (3) whether the customer advised the broker that part of the stock would be delivered immediately and the rest would be delivered by the end of the week (A., pp. 81a-86a). Mr. Monigan admitted that

all of these factors were significant and that another factor would be the assurance of WFSCC that it had instructions to deliver the stock (A., p. 84a). In his capacity as expert for WFSCC, Mr. Monigan opined that E&H gave inappropriate weight to certain of these factors as opposed to the facts of risk to the firm and the need of the street for delivery of the stock and, therefore, arrived at a poor business judgment (A., p. 88a). Mr. Monigan expressly agreed that with two exceptions, a sale of 1000 Halliburton sold on December 15 and a sale of 1500 Texas Instruments sold on December 30, no Regulation T violation occurred in the account (A., pp. 75a-76a). The Court of Appeals went far beyond Mr. Monigan's conclusion in ruling that E&H did not have the right to balance these factors but that the capital risk to the firm was of paramount importance.

The Court of Appeals, in holding that lack of due diligence can be a defense to securities fraud, reaffirmed its holding in *Hirsch* v. *duPont,* 553 F.2d 750 (2d Cir. 1977). The ruling is contrary to the rulings of the Fifth, Seventh and Tenth Circuits, *Dupuy* v. *Dupuy,* 551 F.2d 1005, 1017-20 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1977); *Sundstrand Corp.* v. *Sun Chemical Corp.,* 553 F.2d 1033, 1040 (7th Cir. 1977), *cert. denied* 434 U.S. 875 (1977); *Holdsworth* v. *Strong,* 545 F.2d 687 (10th Cir. 1976), *cert. denied* 430 U.S. 955 (1976).

This Court declined the invitation in *Dupuy* to review the conflict among among the Circuits, Mr. Justice White dissenting. The decision of the Second Circuit in the instant case exacerbates the conflict among the Circuits, encourages forum shopping in the area of the functioning of the securities markets where uniformity is of national concern and further raises the serious moral dilemma of whether the denial of relief to the victims of a deliberate fraud because of their own alleged negligence encourages falsehood and dishonesty. See *Holdsworth* v. *Strong,*

supra, 545 F.2d 687, 692-693. Therefore, a resolution of this conflict has become even more compelling and immediate and should be resolved now.

Moreover, the Court of Appeals ruled, again in the context of a proximate cause analysis, that Regulation T violations by E&H could be a defense to an action in fraud. This conclusion again raises a novel issue requiring resolution by this Court.

In *Pearlstein* v. *Scudder & German,* 429 F.2d 1136, 1140-41 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971) ("Pearlstein I") the Court of Appeals for the Second Circuit recognized an implied right of action under § 7 of the Securities Exchange Act of 1934 and Regulation T on behalf of a customer whose brokerage firm failed to comply therewith. In *Pearlstein* v. *Scudder & German,* 527 F.2d 1141, 1145 (2d Cir. 1975) ("Pearlstein II") and in several district court cases the continued vitality of this cause of action has been questioned. See, e.g., *Newman* v. *Pershing & Co.,* 412 F.Supp. 463, 468 n.7 (S.D.N.Y. 1975); *Bell* v. *Winer & Co.,* 392 F.Supp. 646, 652-54 (S.D.N.Y. 1975), *Schy* v. *Federal Deposit Insurance Corp.,* 465 F.Supp. 766 (E.D. N.Y. 1977). Subsequent to *Pearlstein I,* Congress enacted § 7(f) of the Exchange Act and the Federal Reserve Board promulgated Regulation X, 12 C.F.R. § 224, making it unlawful to obtain credit in violation of margin requirements. The Tenth Circuit has interpreted the enactment of Regulation X as an overturning of the *Pearlstein I* doctrine and depriving investors of a right to sue, *Utah State University of Agriculture and Applied Science* v. *Bear Stearns & Co.,* 549 F.2d 164 (10th Cir. 1977), *cert. denied,* 434 U.S. 890 (1977).

The Second Circuit's ruling that violations of Regulation T may be asserted as a defense to an action in fraud was apparently raised in only one case prior to the enactment of Regulation X, *Grimes, Hooper & Messer, Inc.* v. *Pierce,* Fed. Sec. L. Rep. Par. 95,341 (C.D. Cal. 1973), *aff'd per curiam,* 519 F.2d 1089 (9th Cir. 1975).

It is apparently an open and serious question as to whether, if a customer may not pursue a cause of action for a violation of Regulation T known to the customer, a perpetrator of a securities fraud who induces a violation may assert that violation as a defense to its fraudulent actions. It is submitted that this unresolved issue should be settled now by this Court.

The Court of Appeals engaged in substantial appellate fact finding, finding facts neither contained in the record nor accurate and reversing findings of fact of the District Court although the findings were not clearly erroneous thus calling for the intervention of this Court.

The Court of Appeals, in ruling that E&H had violated Regulation T and had failed to exercise due diligence made numerous findings of fact which were either not in the record developed in the District Court or which were contrary to specific findings of the District Court although admitted by the Court of Appeals not to be clearly erroneous. Among the facts were the following:

(1) E&H delivered stock of its own customers or other brokers to cover the Richardson fails by either borrowing the stock or using stock in the house (A., p. 18a). Although the specific factual finding to that effect was deleted in October 1979 by a correction in the Court's opinion (A., p. 27a), the legal conclusion that such events took place and that they were improper is still contained in the opinion (A., pp. 23a and 24a). In fact, no record was made in the Court below to support this allegation and to the best of E&H's knowledge, it is untrue. Moreover, no authority is cited by the Court of Appeals that such conduct on the part of E&H, if it occurred, was in violation of any law, rule or regulation or was evidence of any such violation and none is known.

(2) Some of Richardson's excess sales from third market operations legitimately would be short sales if it wanted to dispose of its own position before excess stock was delivered to it (A., pp. 19a-20a). There is no basis in the record below for a finding that Richardson ever legitimately engaged in short sales and, indeed, the normal business of Richardson in matching trades would militate against any of its legitimate trades being short sales. In that regard, the Court of Appeals apparently erroneously interpreted a short sale to be any sale where the stock was not in the physical possession of the seller.

(3) Deliveries in the Richardson account were "inordinately late" (A., p. 20a). This finding of fact ignored the finding of the District Court that three week delays in delivering on a broker-to-broker transaction are not uncharacteristically late in the industry (A., p. 67a). It is conceded by the Court of Appeals that with the exception of one failed trade in Texas Instruments, all of the trades which ultimately failed were no more than 35 days old when Richardson closed its doors (A., pp. 8a-9a). Thus, the Court of Appeals ignored established brokerage custom as well as the finding of the Court below that the custom was in existence in reaching its conclusion.

(4) E&H wrongfully relied on the responses of Richardson itself to sporadic inquiries. This finding ignores the carefully designed program of partial deliveries during the period involved (see the schedule of deliveries annexed as A,, p. 102a) and the specific finding of the District Court that these partial deliveries coupled with assurances that the remaining stock would be delivered constituted sufficient basis for E&H's reliance and failure to buy in the account (A., pp. 63a-64a).

(5) Four other brokers stopped doing business with Richardson and proceeded to buy in for Richardson's account because of late deliveries (A., p. 23a). In fact, the particular business relationship between the brokers who

bought in the account as opposed to those who did not and who were ultimate victims of the fraud was never explored in the Court below. The attribution by the Court of Appeals of negligence to E&H for failing to do what other brokers apparently did, without knowledge of the background or reasons for the other brokers' actions or any evidentiary support for the conclusion, is a clear case of a wrongful appellate fact finding which resulted in a reversal based upon inadequate knowledge of the facts purported to be found.

The Court of Appeals justified its excursion into appellate fact finding by holding that negligence was a mixed question of fact and law and thus the Court was not necessarily bound by the limitations of Rule 52(a) of the Federal Rules of Civil Procedure, citing *Mamiye Bros.* v. *Barber S.S. Lines, Inc.*, 360 F.2d 774, 776-78 (2d Cir. 1966), *cert. denied*, 385 U.S. 835 (1966) (A., p. 16a). However, the Court of Appeals did not undertake to decide a question of ordinary negligence but rather a question of whether a specific trade and business practice in a complicated industry constituted negligence. Such a ruling clearly violates the command of this Court that a Court of Appeals in reviewing the findings of a District Court sitting without a jury must constantly have in mind that its function is not to decide factual issues *de novo*, see *United States* v. *United States Gypsum Co.*, 333 U.S. 364, 394-395 (1948); *Zenith Radio Corp.* v. *Hazeltine Research Inc.*, 395 U.S. 100 (1969); *U.S.* v. *Yellow Cab Co.*, 338 U.S. 338 (1949).

Other Circuit Courts of Appeals have recognized the applicability of the "clearly erroneous" test to various defenses asserted in actions under the Federal Securities Laws, *Mader* v. *Armel*, 461 F.2d 1123 (6th Cir. 1972), *cert. denied*, 409 U.S. 1023 (1972) (whether a person is a "controlling person" or whether another person acted in good faith and did not induce the violation), *Wolf* v. *Frank*, 477

F.2d 467 (5th Cir. 1973), *cert. denied*, 414 U.S. 975 (1973) (applicability of the defense of unclean hands).

The District Court specifically found that a three week delay in delivery of stock was not uncharacteristically late by industry standards. The District Court further found, after hearing the testimony of all of the witnesses including defendants' own experts, that none of the activities of Richardson were sufficient to place E&H on notice that Richardson was selling short. The Court of Appeals' reversal of these findings, admittedly not based on a "clearly erroneous" test, is unquestionably improper as well.

It is self-evident that the Court of Appeals by engaging in such appellate fact finding deprived E&H of the opportunity to explain and refute the findings of fact which would have been accorded to it had the matters been raised in the District Court. This fundamental error caused a clear miscarriage of justice and requires this Court's intervention to correct it.

CONCLUSION

The Petition for a writ of certiorari should be granted.

Dated: November 20, 1979.

Respectfully submitted,

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OPINION OF THE COURT OF APPEALS

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 606—August Term, 1978.

(Argued February 14, 1979 Decided June 27, 1979.)

Docket No. 78-7524

EDWARDS & HANLY,

Plaintiff-Appellee,

—against—

WELLS FARGO SECURITIES CLEARANCE CORPORATION,

Defendant-Appellant.

Before:

MULLIGAN and GURFEIN, *Circuit Judges,*
and POLLACK, *District Judge.**

Appeal from a judgment of the United States District Court for the Southern District of New York (the Hon. Lee P. Gagliardi, *Judge*). A broker-dealer sued a clearing agent in New York, affiliated with a California bank, for aiding and abetting a violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 by a third market broker in California which customarily disposed of excess shares in third market matching trades of listed securities through the plaintiff in a cash against delivery account. Without the knowledge of the bank or of the plaintiff, the third

* The Honorable Milton Pollack, United States District Judge for the Southern District of New York, sitting by designation.

market broker, which was secretly selling "glamour" stocks short for its own account, induced the president of the clearing agent to put through clearances for it without disclosure to the bank, and to lend money to it interest-free without authorization from the bank or its personnel in charge of supervising the clearance corporation. Plaintiff continuously tolerated excessively late delivery of volatile stocks without buying in. After a trial to the court, the District Court held that the president of the clearing agent aided and abetted the 10b-5 violation by his assistance in financing stock borrowings and clearing unauthorized trades for the third market dealer, and that the clearing corporation was liable to plaintiff on *respondeat superior*, or as a "controlling person" under Section 20(a) of the Exchange Act which had failed to establish "good faith." It entered a money judgment.

The Court of Appeals held that the acts of the president of the clearing agent were not sufficiently proximate to the fraud, which was not the short selling but the failure of its customer to disclose its short selling to the plaintiff. The Court further held that the plaintiff, by its failure to buy in, and its toleration of suspicious late deliveries, had violated Regulation T of the Federal Reserve Board, as a matter of law; and that the proximate cause of its loss was its own conduct.

Reversed with directions to dismiss the complaint.

WILLIAM A. MASTERSON, Los Angeles, California (Milbank, Tweed, Hadley & McCloy, New York, N.Y., and Sheppard, Mullin, Richter & Hampton, Los Angeles, California, of counsel), *for Defendant-Appellant.*

EVAN L. GORDON, New York, N.Y. (Delson & Gordon, New York, N.Y. and Wofsey, Certilman, Haft & Lebow, New York, N.Y., of counsel), *for Plaintiff-Appellee.*

GURFEIN, *Circuit Judge*:

Plaintiff Edwards & Hanly ("E&H") sued Wells Fargo Securities Clearance Corporation ("Clearance Corporation") for alleged violations of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act").[1] The District Court for the Southern District of New York (Hon. Lee P. Gagliardi, Judge) after a non-jury trial, granted judgment for the plaintiff in the sum of $1,441,122.45, plus interest, on the ground that Clearance Corporation had aided and abetted T.P. Richardson & Co. ("Richardson"), a California broker-dealer, in committing a Section 10(b), Rule 10b-5 fraud, which caused damage to the plaintiff. *Edwards & Hanly v. Wells Fargo Security Clearance Corp.*, 458 F. Supp. 1110 (1978). For reasons that will appear, we are constrained to reverse the judgment and to order a dismissal of the complaint.

The able District Court made detailed findings of fact and we refer for details to its comprehensive opinion.

Richardson:

Richardson was a registered broker-dealer, based in Los Angeles, which specialized as an institutional broker in the so-called "third market," that is, the over-the-counter market in securities which are listed on the major stock

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1 15 U.S.C. § 78j(b). Plaintiff also sued for alleged violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q, and common law fraud. Jurisdiction was predicated on § 27 of the Exchange Act, § 22 of the Securities Act and pendent jurisdiction.

exchanges. Richardson matched buy and sell orders of large blocks of listed stocks made by large financial institutions. Richardson, in matching buy and sell orders, was a buyer or seller on its own, for it made its profit on the difference in price agreed to by the institutional buyer and seller. Although Richardson was generally able to match the buy and sell orders exactly, at times it would effect an unmatched trade in order to accommodate one of its institutional clients. In such instances, Richardson would take a position on the shares which were in excess after the matching of orders. To eliminate these excess positions, Richardson used the services of stock brokers like the plaintiff, Edwards & Hanly, who were members of the New York Stock Exchange, to liquidate such positions as it had assumed.

From February 1974 through April 15, 1975, Richardson maintained a special *cash* brokerage account with E&H on a delivery versus payment, receipt versus payment basis. The account both bought and sold listed securities. The orders were regularly telephoned by Richardson's traders to Dominic Gulemi of E&H's Huntington, New York office. The Richardson account was the largest account in appellee's Huntington office, producing as much as $100,000 in commissions annually. When Richardson was late in delivering stock it had sold, E&H borrowed stock and made delivery to its customers before it actually received the shares from Richardson.

Wells Fargo Bank:

In 1973 Richardson had made a financing arrangement with the Wells Fargo Bank, N.A. ("the Bank") in San Francisco under which the Bank would advance the purchase price for Richardson's account to a seller of securities bought by Richardson, and the certificates sold would then

be delivered to Richardson's buyer and the purchase price would be collected. In clearing these institutional third market trades for Richardson, the Bank utilized Clearance Corporation, its clearing agent in New York, the defendant-appellant herein, to handle the receipt and delivery of the cash and securities.[2] The Bank collected interest from Richardson from the time it advanced funds for the Richardson account until it collected the purchase price. The funds which it advanced to Richardson and to some 70 other brokers through the Clearance Corporation account in the Morgan Guaranty Bank in New York were "federal funds", *immediately* available to it when deposited. Its clearing agent in New York, appellant herein, nevertheless paid sellers of securities to the broker in *regular* funds, drawn on a bank on the West Coast, which did not clear for several days. This created a "float" or a continual lag which enabled appellant to invest the money in commercial paper and certificates of deposit, collecting interest on such instruments. Under the procedure that was prescribed by the Bank, Richardson would deliver confirmation slips to the Bank in Los Angeles, which would then instruct Clearance Corporation in New York. When Richardson sold stock through brokers in New York, it would deliver the certificates sold to Clearance Corporation and the buyer would receive the certificates upon payment. When Richardson bought stock, it would instruct appellant through the Bank to pay against delivery. Clearance Corporation did not have authority to clear any trades for Richardson without first receiving instructions from the Bank. 458 F. Supp. at 1114.

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2 Clearance Corporation was wholly owned by Wells Fargo Company which also owned the Wells Fargo Bank.

***The short selling*:**

Early in 1974, without the knowledge of the Bank, Richardson secretly began to deviate from its regular practice of matching buy and sell orders on institutional trades and began to speculate for its own account. Richardson embarked on a program of making massive short sales for its own account of highly volatile "glamour" stocks. By late 1974, this short-selling comprised a substantial part of Richardson's total business.

To cover its short positions, Richardson began to borrow stock. The stock lenders received 100% cash payments of the closing price of the stock on the most recent trading day. The stock loan agreements also required adjustments in the cash collateral as the stock went up or down. These adjustments were called "mark-to-the-market" payments.

In order to generate enough cash to make the "mark-to-the-market" adjustment, Richardson adopted a procedure of falsification. First it falsified its records by creating false order tickets showing that it had purchased stock on a matched order trade between institutions when, in fact, it had borrowed the stock. Richardson then attached these false orders to its instructions to the Bank and, thus, was able to obtain advances from the Bank pursuant to its credit line. By December 31, 1974 Richardson had borrowed in excess of $25 million worth of stock from fourteen different institutions. All this borrowed stock was used for delivery on short sales that had *previously* been made by Richardson.

As a result of a rising market, Richardson was unable to meet the "mark-to-the-market" payments during March and April, 1975. On April 15, 1975, Richardson advised the SEC of its insolvency. By then its stock loans were

undercollaterized by almost $3 million, and over $20 million worth of short sales, principally to broker-dealers like the plaintiff, were not covered by stock.

Upon notice of Richardson's insolvency, these broker-dealers were required to buy-in on the open market. The cash loss to the brokers—the difference between the price at which Richardson sold the stock short and the buy-in price to the brokers—was about $3.4 million. Of that total, appellee sustained a loss of about $1.4 million.

Beginning as early as February 1975, Richardson's biggest brokers, E.F. Hutton, B.C. Christopher, and North American Equity (as well as Kaufman & Co.) informed Richardson that they were buying in their accounts with Richardson and would no longer do any business with it "because of its consistently late deliveries of stock that it had sold to them." 458 F. Supp. at 1117. Richardson thereupon decided to increase the volume of its short sales through E&H "because, by contrast, that firm had never pressed Richardson as hard to make timely delivery." *Id.*[3]

From about March 3, 1975 to April 7, 1975, Richardson in its cash account with E&H sold 23,000 shares of Digital Equipment Corporation, 9,500 shares of E.I. duPont, 2,600 shares of Fairchild Camera Co., 17,500 shares of Halliburton Corp., and 16,500 shares of Texas Instruments. Virtually all of these were, in fact, short sales. *Id.*

Though the standard sales contract between brokers in the industry required delivery within five business days in a "delivery against payment" and "receipt against payment" account, E&H through March 1975 tolerated delays in delivery by Richardson of two to three months in some extreme cases, and delays of two or three weeks as a regu-

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3 *Cf. Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166, 1173 (8th Cir. 1972).

lar practice. No rule or practice precluded E&H from buying in an account once the due date for delivery had passed, but E&H had an obvious disincentive to buy in this particular account because it generated substantial brokerage commissions. 458 F. Supp. at 1118. When Richardson finally went under on April 15, 1975, E&H was then compelled to buy-in about thirty failed trades, almost two-thirds of which were at least three weeks past due. Almost 90% of the short sales which plaintiff had to buy-in were made by Richardson in March, after its other large brokers had closed their accounts with Richardson. *Id.*

Dominic Gulemi was the registered representative at E&H in charge of the Richardson account. He maintained a close personal relationship with many Richardson employees. In 1974, he took three trips to California, including one during which he and the Richardsons planned a joint venture—the establishment of a restaurant business in Los Angeles. 458 F. Supp. at 1118 n.3.

The course of particularly late deliveries on stocks sold to or through E&H by Richardson on the six stocks on which appellee claimed damages was as follows:

(1) *Halliburton*—1,000 shares due November 20, 1974 (4 months); 6,000 shares due December 17, 1974, not delivered until January 17, 1975 (4 weeks); 1,500 due March 7—delivered 500 March 17 and 1,000 March 26 (split delivery); 1,500 shares due March 19—not delivered by April 15; 1,200 shares due March 24, not delivered by April 15. At the time of the insolvency notice of April 15, Richardson had failed to deliver 17,500 shares of Halliburton.

(2) *Texas Instruments*—None of the 18,000 shares sold was delivered, though 5,000 shares were due as early as March 10 (5 weeks); and one sale of 1,500 shares was due January 7 (3 months).

(3) *Digital Equipment*—By April 15 delivery on 23,000 shares was late. Of that amount 7,000 shares were already four weeks late and 7,500 shares were already three weeks late.

(4) *Fairchild Camera*—2,600 shares were never delivered though the delivery date was March 10 (more than a month).

(5) *DuPont*—There was a late delivery on February 7, 1975, of 1,100 shares due on November 18, 1974 (eleven weeks). Richardson sold short 9,500 shares in March which were never delivered, the delivery of some of which was already over a month late.

(6) *Schlumberger*—Showed late deliveries of more than a month with a split delivery in between.

E&H did nothing about these late deliveries except to inquire when the stock would be delivered. It did not buy-in until after April 15, though, as we have seen, other brokers did much earlier.

Joseph C. Werba:

We now turn to the circumstances upon which the District Court found Clearance Corporation liable. Joseph C. Werba, president of Clearance Corporation since April 1974, was friendly with a number of Richardson's employees and would see them socially on his frequent business trips to Los Angeles. Richardson had given Werba and his family generous gifts, including airline tickets to Los Angeles and a vacation weekend on Cape Cod. Beginning in November 1974, Werba made "interest free" loans to Richardson from Clearance Corporation's bank account, previously described as the means for creating the "float" for the earning of interest. Richardson, in turn,

used the advances in attempts to meet its "mark-to-the-market" payments.

Werba had no authority to make these loans without interest, and he failed to inform the Bank or his superiors at Clearance Corporation that he was doing so. The five separate advances totalled over $1 million. The advances were repaid except for the final advance of $500,000 which was made on March 31, 1975, and on which Clearance Corporation lost $309,000 when Richardson became insolvent.

In early December 1974, after the first unauthorized advance, Werba met two Richardson employees for dinner, one of whom was Michael Wawra, its cashier. Wawra explained that Richardson had begun to suffer losses on certain trades and that it did not want the Bank to know for fear that the Bank would terminate its draft line of credit. The Richardson employees persuaded Werba to aid them in concealing the trades from the Bank by handling them on a "special" basis. They proposed that on these trades Richardson should not follow the usual required procedure of routing written instructions through the Bank, but instead Richardson would telephone instructions directly to Clearance Corporation in New York, leaving the Bank without knowledge of the trades.

The District Court found that at a second meeting in Los Angeles Werba was informed of Richardson's short positions and of its desire to hide them *from the Bank*. At dinner with Thomas Richardson, Werba received $2,000 in cash for "helping" Richardson out. 458 F. Supp. at 1117.

From January through March 1975 Clearance Corporation cleared approximately 52 "special" trades for Richardson in breach of the authorized procedure required by the Bank and without its knowledge.

Marianna Ianuzzi was in charge of receiving and delivering securities in the Clearance Corporation office in New York. Werba told her of the "special" trades for Richardson and how to handle them. He did not tell her that these trades were in fact short sales. 458 F. Supp. at 1117. She received her instructions on the "special" trades, thereafter, directly from Richardson and sent handwritten confirmation statements directly to Richardson when the trades were completed.[4]

The unauthorized advances by Werba to Richardson were not discovered by his superiors in Clearance Corporation, because the daily money sheets were sent to the Bank, but not to the Bank officials in San Francisco who were directors of Clearance Corporation and who were charged with its supervision. Morgan Guaranty in New York, where Clearance Corporation had its bank account, did send monthly statements of the account to these directors. These statements did not identify *individual* deposits and withdrawals, but showed the amount of the available "float."

The District Court determined that the defendant Clearance Corporation was liable for the losses of appellant E&H on a theory of vicarious secondary liability. It held that the employee, Werba, was guilty of aiding and abetting Richardson in violating Rule 10b-5 because he "substantially assisted" Richardson in perpetrating the fraud.[5]

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4 A key issue in the trial below was the extent of Ianuzzi's knowledge of the Richardson short selling scheme since she was frequently contacted by E&H employees for information on the late deliveries in the days immediately preceding Richardson's collapse. The District Court found that Ianuzzi remained innocent of the Richardson scheme, and that "until Richardson's demise . . . Ianuzzi remained as much a target of its [Richardson's] fraudulent assurances as Gulemi." 458 F. Supp. at 1123.

5 The District Court applied the three-prong test for aider-abettor liability adopted in *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38,

The District Court then held the defendant corporation liable vicariously as an aider and abettor for the acts of its agent, Werba, on the theory of *respondeat superior* and, alternatively, as a "controlling person" under § 20(a) of the 1934 Act because it had inadequately supervised Werba.

I

Werba, the officer of the appellant who did the alleged aiding and abetting, is not a defendant. Yet, in order to assess the culpability, if any, of Clearance Corporation, we must analyze the actions of Werba, the unfaithful employee.

The determination by the District Court that Werba was not a principal in Richardson's fraud against E&H is sound, for as Judge Gagliardi noted "the allegedly fraudulent sales were between Richardson and the plaintiffs." As we have noted, he held that if Clearance Corporation is liable at all, it must be under a theory of secondary liability—based on Werba's role as an aider and abettor. 458 F. Supp. at 1121.

We conclude that Werba's activities in lending Richardson money, free of interest, and in hiding the special trades *from the Bank* did not substantially assist the violation of 10b-5 by Richardson, which was not the short selling but the failure by Richardson to tell E&H that it was selling short. Nor were such activities the proximate cause of E&H's loss. *See Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 95 (5th Cir. 1975): "A remote party must not

47-48 (2d Cir.), *cert. denied*, 99 S. Ct. 642 (1978), and *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). This test requires proof of (1) fraud by the primary violator (Richardson); (2) knowledge of the primary fraud by the alleged aider-abettor; and (3) substantial assistance. *See also* Restatement (Second) of Torts § 876.

only be aware of his role, but he should also know when and to what degree he is furthering the fraud."

Werba was held to be an aider-abettor on a "but for" theory of causation. The District Court reasoned that "but for" Werba's acquiescence in the "special trade" arrangement and advancement of interest-free funds, Richardson would not have been able to finance or to conceal its massive short sale speculation. We question whether these acts "caused" the loss of E&H in a proximate sense, since that loss was "caused" not by Richardson's short selling but by the failure of Richardson to inform E&H that it was short selling for its own account. In *Landy v. Federal Deposit Insurance Corp.*, 486 F.2d 139, 163-64 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), the Third Circuit construed the "substantial assistance" requirement of aiding and abetting as a causation concept. A "but for" analysis was rejected as insufficient. We agree.

Whether Werba's activities gave such substantial assistance to Richardson as to make him a culpable aider-abettor, even though not a principal, is a question of law. The answer depends not only on whether Werba knew of the fraud, the failure by Richardson to tell E&H that it was short selling, but also on whether Werba had a duty to speak. There is no claim that Werba made any false representation to E&H that Richardson was not selling short. It is his silence in the face of alleged "knowledge" that Richardson was short selling that it is claimed would make him an aider-abettor.[6]

6 Clearance Corporation's directors first learned of the special trades and loans, but not of Richardson's short-selling, on April 1 or 2, 1975, when Gary Bruno, a vice-president of Clearance Corporation, independently decided to inform the Bank of the unauthorized dealings with Richardson. At that time Werba was on vacation in the Virgin Islands. He was summoned to San Francisco for an explanation immediately upon his return on April 7. Werba met with his superiors in San

The trial court recognized that a transfer agent, and similarly a clearing agent, is generally under no fiduciary duty to the owners of the securities that pass through its hands. *Woodward v. Metro Bank of Dallas, supra,* 522 F.2d at 97 & n.29; *see Affiliated Ute Citizens v. United States,* 406 U.S. 128, 151-52 (1972). It decided, nevertheless, to evaluate *scienter* under a "recklessness standard," applying that standard to Werba.

We have not used the "recklessness" standard when money damages are claimed, in an aiding and abetting context, except on the basis of a breach of fiduciary duty. In *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38 (2d Cir.), *cert. denied,* 99 S. Ct. 642 (1978), we held that "recklessness" may be an appropriate standard for *scienter* when there is a fiduciary duty, but we have gone no further. To the extent that Werba is held culpable because he "recklessly" *failed to discover* whether Richardson was telling its brokers that it was short selling, he did not achieve the status of an aider-abettor. "The *scienter* requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing." *Woodward v. Metro Bank of Dallas, supra,* 522 F.2d at 95.

By way of illustration, if a bank lends money to a customer who then uses it to perpetrate a fraudulent scheme, there is probably neither intent nor causation on which

Francisco on April 8 and went from there to meet with the Richardson people in Los Angeles on April 9. Werba returned to New York on April 12 but was suspended from further duties at the office. There is no evidence that Werba ever told anyone at the Bank that Richardson was selling short, nor did Bruno have any knowledge of the short-selling scheme. Whatever knowledge there was of Richardson's fraud, that knowledge remained with Werba until Richardson's collapse. Accordingly, we need not look beyond Werba himself in determining whether there was a duty to disclose Richardson's scheme to E&H.

to find the Bank liable for a 10b-5 violation.[7] On the other hand, for example, if the bank encourages a borrower to sell notes to others without disclosing that they are subordinate to the Bank's own loan, it may become an aider-abettor. *Monsen v. Consolidated Dressed Beef Co.,* 579 F.2d 793 (3d Cir.), *cert. denied,* 99 S. Ct. 318 (1978).

Finding a person liable for aiding and abetting a violation of 10b-5, as distinct from committing the violation as a principal, requires something closer to an actual intent to aid in a fraud, at least in the absence of some special relationship with the plaintiff that is fiduciary in nature. Our difficulty is that the judge concluded that "Werba knew that Richardson was defrauding broker-dealers by failing to disclose its short position *or, at least, recklessly failed to discover Richardson's fraud.*" 458 F. Supp. at 1123. (Emphasis added.)

This falls short of a finding of fact that Werba actually knew that Richardson was not disclosing its short position. Because we do not know which standard the District Judge thought predominant, we would ordinarily remand for the Judge to make an explicit finding. Since the record discloses, however, that the proximate cause of appellee's loss was its own failure to exercise due diligence, we can dispose of the appeal without considering whether, in these circumstances, vicarious liability was properly imposed upon the Clearance Corporation for the acts of its president. In that posture of the case, the standard by which Werba is judged is not controlling and the alleged inadequacy of supervision of its president by appellant is not material.

7 *See Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U.Pa.L.Rev. 597, 630-31 (1972).

Moreover, we do not agree with the legal conclusion of the District Court that appellant could be made liable to the plaintiff broker by inadequate supervision of Werba. There was no reasonably foreseeable consequence of harm to appellee by the gaps in the supervision of Werba.

The failure to tighten the supervision of Werba could harm only the Bank itself. It was lending money on the interim collateral of stock certificates that passed through Clearance Corporation simply as a collection mechanism to protect its own interest. It was not within its function to alert brokers on whether their own transactions were long or short, cash or margin, to be handled in individual or omnibus accounts. The transactions were between the brokers themselves. No one should have known better what the transactions were than those who made them.

II

The District Court, in the context of an affirmative defense, held that E&H was not negligent.[8] We approach the issue of E&H's conduct from the standpoint of causation and due diligence. In any event, negligence is a mixed question of fact and law, and we are not necessarily bound by the limitations of Rule 52(a). *Mamiye Bros. v. Barber S.S. Lines, Inc.*, 360 F.2d 774, 776-78 (2d Cir.), *cert. denied*, 385 U.S. 835 (1966); *see Karavos Compania Naviera v. Atlantica Export Corp.*, 588 F.2d 1, 7-9 (2d Cir. 1978). This is even clearer when the decision on negligence is supported by a misconstruction of a relevant regulation, such as Regulation T.

We have studied the record carefully, and we have come to the conclusion that E&H failed to exercise due diligence as a matter of law by not discovering (1) that the massive

8 This was appellant's 21st affirmative defense.

selling by Richardson was for its own account; (2) that the late deliveries indicated short selling by Richardson; (3) that the frequent lateness in delivery should have put it on notice that something was seriously amiss; (4) that the cashier's department failed to press the salesman on the Richardson account to get information about late deliveries from Richardson; (5) that the responsible people at E&H for a long time did not know how much credit was outstanding to Richardson; (6) that the firm failed to press Richardson directly for credible answers on why deliveries were so late on huge sales of volatile glamour stocks; and (7) that it violated Regulation T, 12 C.F.R. § 220.4, and possibly also 17 C.F.R. §§ 240.10a-1(d), 240.10a-2(a) (or earlier equivalents), by failing to inquire, in view of Richardson's pattern of late deliveries, whether the sales it marked "long" were actually long sales, and by failing to buy in at a reasonable time.

In sum, we have concluded that E&H, having caused its own loss, is now seeking to put the blame on the clearing agent.[9] As we said in *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977): "The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment."

The primary cause of E&H's loss was its failure to comply with Regulation T, 12 C.F.R. § 220.4, pursuant to § 7 of Exchange Act, 15 U.S.C. § 78g. We cannot condone the failure of E&H to press Richardson on late deliveries in such large amounts. Regulation T provides that a purchase

9 As Judge Murrah observed in *Naftalin & Co. v. Merrill Lynch*, *supra*, 469 F.2d at 1181: "We have no doubt that under Section 7 and Regulation T as presently structured, a broker/dealer who has entered into a special cash account transaction in good faith, but who has not acted diligently to sustain his good faith belief that prompt delivery will be made, cannot excuse his negligence by placing all the blame upon a customer that has deceived him" (footnote omitted). Here, of course the "customer" (Richardson) is not a defendant.

or sale may not be made by a broker firm or customer in a special cash account, unless "the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account." 12 C.F.R. § 220.4(c)(1)(ii). Richardson's status as a registered broker-dealer did not prevent it from also being a customer for purposes of Regulation T. *See* 12 C.F.R. § 220.101(b); 2 L. Loss, Securities Regulation 1250 n.35 (2d ed. 1961).

There is no evidence that E&H ever agreed with Richardson that the securities would be delivered at a stipulated date beyond the five day period for delivery. Even if E&H at first thought that Richardson's sales were long, it was on notice of its obligation to cover the open position on late delivery, unless it knew or had been informed by the seller either (1) that the securities were in transit, or (2) that the seller *owned* the securities, that it was then impractical to deliver them, and that the securities would be delivered as soon as possible without undue inconvenience or expense. If the broker did not have such knowledge, it had no right to borrow stock to deliver to its own customer, but was under a duty to cover the transaction by buying in for "cash," for the account of the customer, the securities sold. 2 L. Loss, *supra,* at 1233.

Here, in the face of a succession of late deliveries by Richardson, E&H delivered stock of its own customers or other brokers apparently by borrowing the stock or using stock in the house. In addition to its careless attitude in marking the Richardson sales "long" (which alone might not be a breach of duty, *see Naftalin & Co. v. Merrill Lynch, supra,* 469 F.2d at 1175), the moving cause of its loss was its own negligence, in the face of repeated failure to de-

liver stock due from Richardson, in continuing to do business on that basis, and in failing to press for specific answers to explain the lateness of particular deliveries. Its sporadic inquiries of the clearing agent were not legally sufficient in the circumstances, considering the size of the "fails," the history of the dealings with Richardson, and the omission to observe the requirements of even a relaxed interpretation of Regulation T and of the Commission's rules. Moreover, if there was an intervening efficient cause for its loss, it was its reliance on the responses of Richardson itself to sporadic inquiries. These responses were evasive, and E&H had no right to rely on them unless they afforded a "credible" reason for the delay in delivery of the securities. *See Naftalin & Co. v. Merrill Lynch, supra,* 469 F.2d at 1177 & n.14. Since the transactions were effected directly between broker-dealer (E&H) and broker-dealer (Richardson), it is quite inexplicable that credible explanations for late delivery should not have been demanded of Richardson itself. This failure to press Richardson for the specific reasons for the particular delays and whether the purported long sales were not, in fact, short sales, can only be attributed to E&H's desire for commissions and its willingness to extend credit, if necessary, in the cash account.

If E&H believed that Richardson was the seller for its own account, it failed to fulfill its obligations, as we have noted. If the sale was by a broker, like Richardson, for an account in which Richardson had no interest, it was the duty of E&H to inquire whether that was so. The record establishes that E&H failed to inquire initially, or even after failure to deliver promptly, whether the particular sale was "long" and, indeed, whether it was of stock owned by Richardson or by a customer of Richardson. Gulemi conceded that he never asked whether Richardson's sales were short or long, though some of Richardson's excess sales

from third market operations legitimately would be short sales if it wanted to dispose of its own position before excess stock was delivered to it. But in such case, the broker could not mark the sale as "long" and the requirements for short selling would apply.

E&H produced no expert evidence to support the contention that the deliveries were not inordinately late. The objective evidence speaks for itself. Foote, the cashier of E&H, conceded as being "extraordinarily late" a 1,000 share fail in Halliburton, a du Pont trade on November 11, with delivery delayed until February 7, two Schlumberger trades extending over a three month period and a Texas Instruments trade, executed December 30, due January 7, 1975 and never delivered.

The only excuse given for the failure of E&H to press Richardson harder, which came from Foote, was that the cashier's department was not permitted to call a customer; this had to be done through the salesman on the account. Whether there was a lack of liaison between cashier and salesman, or whether Gulemi, friendly to his customer, Richardson, suppressed inquiry, is not clear.

What is clear is either that the internal controls of E&H, until the last week of March, failed to point up the credit balances that had been accumulating in Richardson's account because of its failure to deliver stock, or that the information was disregarded. In the last week of March, when E&H transferred the clearing functions for its retail accounts to another firm, it retained for itself the clearing function for institutional clients like E&H. After the transfer effective March 27, it appeared quite clearly that Richardson's failure to deliver accounted for a large percentage of E&H's outstanding institutional credit balances. The Richardson balance "stuck out like a sore thumb." 458 F. Supp. at 1119 & n.5.

Before the partial transfer of the clearing function to another firm, Bert G. Edwards, the managing partner of E&H, noticed in the middle of March that there was a large credit balance in one account and, upon inquiry, learned that this was Richardson's account. Edwards testified that he thereupon "established that we wanted to get the stocks in, that there were too many stocks out for one account, and we wanted to get them in as soon as possible. We had the assurance of everyone working in the case that they would get right to work on it, and put the pressure on and we would start to get the stock."

A delivery of one stock came in shortly thereafter and E&H had to make a policy decision. Checking the market price on that day "there appeared to be little or no risk." Edwards testified: "If we had to buy them in there would have been a profit and the profit of course would have gone to Richardson. But we would have lost the account, and probably the registered representative as well."

At this point Edwards consciously assumed a market risk for E&H. Clearance Corporation did not encourage him to accept further orders from Richardson, nor did it participate in the negotiation of such sales.

When asked whether he put any pressure on Richardson or tried to reach it directly, Edwards replied that he put pressure on his own employees, and sat by once while his employee, Jim Barbi, put in a phone call to Richardson "and he was not successful in talking to someone."

On April 7, an E&H margin clerk calculated that Richardson owed the plaintiff over $7 million in stock and informed Gulemi. Gulemi called Wawra, the Richardson cashier, "who falsely attributed the delay to the failure of Richardson's clients to deliver it stock and promised delivery within a week." 458 F. Supp. at 1119. O'Hare, the Huntington branch manager, subsequently spoke to Wawra

and found him to be evasive. It must have been obvious that since several different stocks were involved there could hardly be a single legitimate cause for a common failure to deliver, nor would it be likely that there was a common single basis for an assurance of simultaneous delivery by the end of the week. The natural inference was that Richardson was short and did not have the stock to deliver.

On April 7, the market had moved upward and continued to move upward. When asked what he did about the Richardson account that week, Edwards replied: "I didn't do a great deal except to stay on top of it." Finally, Edwards testified that three business days before the Richardson failure, he brought a lot of pressure to bear. This "pressure," it turned out, was that "I just talked to the people who would bring the pressure." This apparently included the frustrated call to the Richardson cashier who could not be "reached."

Still, instead of "buying in" the late shares, Edwards was planning to give Richardson a "margin call" requiring Richardson to put up $300,000 to $400,000 to cover the failed trades. He testified that he knew that Richardson was an "in-between" house which would "try to bring a buyer and seller together and if there is a residue they absorb it or sell it for themselves"; hence, as a house short of capital, Edwards thought that Richardson would prefer to deliver the stock rather than meet the margin call. He said he held this quixotic belief in spite of his admission that he knew the credit balance was six or seven million dollars and that the risk to E&H had increased.

Edwards never inquired about the pattern of deliveries in the Richardson account in any attempt to evaluate the nature of the account or the risk. As early as February 1975, Gulemi told Wawra at Richardson that "people are

getting nervous."[10] In spite of the February nervousness, no action was taken. At the same time, four other brokers, as noted above, stopped doing business with Richardson and proceeded to "buy in" for Richardson's account because of late deliveries.[11]

When, in the face of late delivery, E&H borrowed stock to deliver, it was acting contrary to the requirement of Regulation T, as well as 17 C.F.R. § 240.10a-2(a), since it did not know that Richardson actually owned the stock it had sold.[12]

In any event, it was with Richardson, not the Clearance Corporation, that E&H transacted the purchases and sales. If there was late delivery, E&H had direct contact with Richardson by telephone and could ask it directly why there was delay in delivery.[13] The timing of stock delivery was entirely in the hands of Richardson, the seller, and not in the hands of the clearing agent. When E&H chose to ask the clearing agent instead, it was like asking a bank when

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10 The nervousness can only be attributed to a fear that Richardson might not get the stock in, *i.e.*, that it had no control over the stock it had sold.

11 Foote, the head cashier of E&H, conceded that from April 6 on "[i]t probably should have, but it didn't" cross his mind that these were short sales because "I wasn't getting an answer or delivery of securities for a clearing in this account."

And Gulemi was concerned enough to tell his manager, O'Hare, that one of the principals should call and speak to Richardson "direct." During that week of April 7 to April 15 Gulemi spent his time "[h]oping and praying stock would come in." He and O'Hare also called Richardson daily.

12 E&H was not induced or aided by Clearance Corporation to handle the transactions in this way. It is significant, moreover, that Clearance Corporation is not charged with lending stock to Richardson to make it appear as if Richardson owned the stock.

13 Indeed, there was a special open wire between the Richardson office in California and the E&H office in Huntington.

a depositor would deposit a check or like asking a librarian when a borrower would return a book.

Indeed, Ianuzzi, to whom the inquiries were directed at the clearing agent, was found by the trial court to have known nothing about the short selling by Richardson. Reliance on the clearing agent was not justified when the line was open directly to Richardson, the seller. Richardson would certainly have been in a better position to know when delivery could be expected by E&H, and Clearance Corporation would reasonably expect the brokers to call Richardson for precise information.

It is also of significance that E&H actually heard a timely rumor that Richardson was "short" and in trouble, and put it aside. The only check made on the rumor was, apparently, a casual inquiry of Ianuzzi whether she, too, had heard the rumor. There was no pressure on Richardson for an explanation, even in the face of the unusual circumstance that some shares had failed to be delivered a second time while the first fail in the *same* stock had not yet been remedied.

The only fair inference from the record is that the appellee had every reason to believe that things were amiss at Richardson and that its indulgence of that firm was at its own risk for its own business reasons. When it borrowed stock to deliver to its own customers to make up for the lateness of Richardson, and permitted that lateness to become extraordinary, it was carrying its indulgence to a dangerous extreme, for that conduct affected its capital ratio. The protection of investors, which is the prime purpose of the securities laws, requires more vigilance than that. Broker-dealers have too much responsibility to the public to allow slipshod methods to serve as an excuse.[14]

14 "[T]he sale of a security which has not been delivered by the customer is just as much an extension of credit as the purchase of a security for which the customer has not made payment. . . . Liquidation of such an illegal extension of credit by buying-in the undelivered stock is an absolute necessity if the integrity of the regulation ["T"] is to be preserved and its policy effectuated. It is, thus, manifest that the duty to liquidate such a transaction is clearly implied in the absence of a provision specifically directing it." *Naftalin & Co. v. Merrill Lynch*, *supra*, 469 F.2d at 1176 (citation omitted).

The third party should not be cast in liability for this plaintiff's own failures.

Appellant resorted to no subterfuge to keep E&H from asking Richardson directly to tell them what was going on. *Cf. Hirsch v. du Pont*, *supra*, 553 F.2d at 762-63. The unsatisfactory state of affairs was the result of E&H's failure to exercise due diligence in demanding straight answers from Richardson or doing something about it. This failure to act was the effective cause of its loss. Its ingredients are historical:

> "The common law affords to everyone reasonable protection against fraud in dealing, but it does not go to the romantic length of giving indemnity against the consequences of indolence and folly, or a careless indifference to the ordinary and accessible means of information." 2 Kent, *Commentaries* 485.[15]

The judgment is reversed with direction to dismiss the complaint.

15 Cited in Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Lawyer 147, 164 (1976).

Corrections to Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
UNITED STATES COURTHOUSE
FOLEY SQUARE
NEW YORK 10007

A. DANIEL FUSARO
Clerk

Edwards & Hanly v. Wells Fargo — August Term, 1978
Docket No. 78-7524 — Decided June 27, 1979

Page 3386, lines 23, 24, 25, 26—delete entirely and insert "commissions annually." in place thereof.

Page 3400, lines 27, 28, 29, 30—delete entirely and insert "In addition to its careless attitude in" in place thereof.

Page 3399, line 1—delete "account; (2)" and insert "account and (2)" in place thereof.

Page 3399, line 2—delete ";" and insert "." in place thereof.

Page 3399, line 3—delete "(3) that" and insert "The record compels the further conclusions: (3) that" in place thereof.

A. DANIEL FUSARO
Clerk

ADF/hjd

Judgment of the Court of Appeals.

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-seventh day of June, one thousand nine hundred and seventy-nine.

Present: HON. WILLIAM H. MULLIGAN
Circuit Judge

HON. MURRAY I. GURFEIN
Circuit Judge

HON. MILTON POLLACK
District Judge

EDWARDS AND HANLY Plaintiff-Appellee, v. WELLS FARGO SECURITIES CLEARANCE CORP., Defendant-Appellant.	78-7524 (SEAL)

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

Judgment of the Court of Appeals.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed in accordance with the opinion of this court with costs to be taxed against the appellee.

A. DANIEL FUSARO,
Clerk

ARTHUR HELLER
By: Arthur Heller,
Deputy Clerk

Order of the Court of Appeals denying Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-eighth day of August, one thousand nine hundred and seventy-nine.

Present: HON. WILLIAM H. MULLIGAN
HON. MURRAY I. GURFEIN
Circuit Judges

HON. MILTON POLLACK
District Judge

EDWARDS and HANLY, Defendant-Appellant —against— WELLS FARGO SECURITIES CLEARANCE CORP., Plaintiff-Appellee	(SEAL) 78-7524

A petition for a rehearing having been filed herein by counsel for the plaintiff-appellee.

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

A. DANIEL FUSARO
A. Daniel Fusaro,
Clerk

Order of the Court of Appeals denying rehearing in banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-eighth day of August, one thousand nine hundred and seventy-nine.

EDWARD AND HANLY Plaintiff-Appellee v. WELLS FARGO SECURITIES CLEARANCE CORP. Defendant-Appellant	(SEAL) 78-7524

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiff-appellee, Edward & Hanly, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

IRVING R. KAUFMAN
IRVING R. KAUFMAN, Chief Judge

Opinion of the U.S.D.C., S.D.N.Y. (Gagliardi, D.J.)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

EDWARDS & HANLY, Plaintiff, —against— WELLS FARGO SECURITIES CLEARANCE CORP., Defendant.	75 Civ. 4566 OPINION

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Opinion of the U.S.D.C., S.D.N.Y. (Gagliardi, D.J.).

GAGLIARDI, D.J.

Plaintiff Edwards & Hanly commenced this action against the Wells Fargo Securities Clearance Corporation ("WFSCC") alleging violations of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78b, § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q, and common law fraud. Jurisdiction is predicated upon 15 U.S.C. §§ 78aa, 77v and principles of pendent jurisdiction. This action was tried to the court, and the following constitutes its findings of facts and conclusions of law pursuant to Rule 52(a), Fed. R. Civ. P. The court determines that plaintiff has proved all the elements of a § 10(b) cause of action and is entitled to recover its damages.

Statement of Facts

Edwards & Hanly is a New York limited partnership engaged in the business of investment banking and a registered broker-dealer of securities pursuant to § 15 of the Exchange Act, 15 U.S.C. § 78o. Defendant WFSCC, an Arizona corporation with its principal place of business in New York, is a wholly-owned subsidiary of Wells Fargo & Company, a holding company among whose subsidiaries is Wells Fargo Bank, N.A. ("WFB"). WFSCC was organized in 1970 to serve as WFB's New York clearing agent for securities transactions involving WFB's clients.

In 1974, Edwards & Hanly acquired the Huntington, New York office of duPont, Walston & Co., including the account of a customer named T.P. Richardson & Co. ("Richardson"). Richardson was a registered broker-dealer, based in Los Angeles, which specialized as an institutional broker in the so-called "third market," *i.e.*, the over-the-counter market in securities listed on the major stock exchanges. (Testimony of Richard Gulemi, Tr. 189 and Stipulation of Facts, ¶¶ 2, 5). Richardson employed approximately fifteen traders who would match

buy and sell orders of large blocks of listed stocks made by large financial institutions (*e.g.*, banks, mutual funds, insurance companies and universities), without using the facilities of a national securities exchange. (Stipulation of Facts ¶ 5). Richardson made a profit equal to the difference between the price at which it purchased stock from the seller and the price at which it sold the stock to the buyer on the matched trade. (*Id.* ¶ 6). Although its traders were generally able to match buy and sell orders exactly, Richardson would at times effect and unmatched trade in order to accommodate one of its institutional clients. (*Id.*, ¶ 7). For example, if such a client wished to sell 10,000 shares of a given stock issue, Richardson would purchase the shares even though it may have been able to find buyers for only 9,000 shares. Richardson would thus buy for its own account and risk, *i.e.*, take a "long" position, 1,000 shares of stock to effect the trade. Conversely, Richardson may have found a buyer of 10,000 shares but sellers for only 9,000. To effect this trade, it would commit to deliver all 10,000 shares to the buyer and take a 1,000 share "short" position for its own account. Richardson's announced business policy was not to maintain positions, short or long, to protect its capital from market fluctuations. To eliminate these positions, Richardson would use the services of stock brokerage firms who were members of the New York Stock Exchange, including Edwards & Hanly, through whom Richardson would, as quickly as possible, sell its long positions or buy stock to cover its short positions. (*Id.*).

From February, 1974 through April 15, 1975, Richardson maintained a cash brokerage account with Edwards & Hanly on a delivery versus payment, receipt versus payment basis. (Gulemi, Tr. 189). The account both purchased and sold securities, primarily "blue chip" and "glamour" stocks listed on the New York Stock Exchange. The

orders were regularly telephoned by Richardson's traders to Dominic Gulemi of Edwards & Hanly's Huntington office. (*Id.*, Tr. 184). Edwards & Hanly's role was solely to execute the orders called in; advice was neither sought nor received from Edwards & Hanly personnel concerning any of the trades in question. The Richardson account was the largest account in plaintiff's Huntington office (O'Hare, Tr. 270), constituting 10-20% of its business (Gulemi, Tr. 217).

In 1973, in order to clear its third market trades, Richardson & Co. established a $10,000,000 secured internal guidance draft line with WFB in Los Angeles. (Stipulation of Facts, ¶ 12). Under this draft line, WFB advanced funds for Richardson's account to a seller of securities bought by Richardson and the certificates would then be delivered to Richardson's buyer against payment of the purchase price. WFB collected interest from the time that it advanced funds for the Richardson account until it collected the purchase price from the buyer. (*Id.*) In clearing these trades for Richardson, WFB utilized WFSCC as its agent to handle the receipt and delivery of cash and securities in New York. (*Id.*, ¶ 14). At the end of each trading day, Richardson sent instructions by messenger to WFB in Los Angeles with respect to that day's matched trades on behalf of its institutional customers. WFB received from Richardson confirmation slips for both the buy and sell sides of the trade. (Bowman; Tr. 413). These instructions were then placed on bank forms by WFB's clerical personnel and forwarded by air to WFSCC in New York so that WFSCC received instructions on both sides of the trade simultaneously (*Id.*).

In a matched trade, Richardson would instruct the seller to deliver the stock to WFSCC. (Stipulation of Facts ¶ 17). Upon receipt of the stock from the seller, WFSCC would pay the seller with funds advanced to WFSCC by WFB from Richardson's draft line of credit. The stock

served as collateral to WFB and WFSCC for the advance. WFSCC then notified the buyer that the stock was in its possession and, in most instances, the buyer delivered a check to WFSCC and it delivered the stock to the buyer that same day. (*Id.*)

WFSCC did not have the authority to clear any trades for Richardson without first receiving instructions from WFB. (*Id.;* ¶ 16). WFSCC's personnel, however, were permitted to contact Richardson on an informal basis if, because of the time differential between New York and Los Angeles, an early delivery of securities was made to WFSCC for which it had no instructions. (Werba, Tr. 36, 56; Holroyde, Tr. 440-41). Nevertheless, WFSCC was not to act on any informal instructions but was required to await confirmatory instructions from WFB (*Id.,* Tr. 56-57).

In the summer of 1974, Richardson fell behind in its payments to WFB of interest and service charges and WFB suspended clearing for the account (Holroyde, Tr. 436). Clearing services were resumed after Richardson and WFB entered into an agreement which required, *inter alia,* that Richardson maintain a $150,000 compensating balance in its commercial account with WFB. (Bowman, Tr. 417 & Plaintiff's Exhibit 9). Richardson's subsequent failure to meet some of the conditions set forth in the agreement prompted WFB to demand, in December 1974, that Richardson meet even more stringent conditions, including the maintenance of a $200,000 compensating balance in its account (Bowman, Tr. 418, & Exhibit 10). Richardson met these new requirements and clearing services were continued by WFB (Holroyde, Tr. 437).

Unbeknownst to WFB, early in 1974, at the direction of its president and majority shareholder Thomas P. Richardson, Richardson began to deviate from its regular practice of matching buy and sell orders and began to speculate for

its own account. Richardson embarked on a program of making massive short sales of highly volatile "glamour" stocks. (Plaintiff's Exhibit #5, Stipulation between United States of America and Thomas P. Richardson ¶¶ 25-29). By late 1974, this short-selling comprised a substantial part of Richardson's total business (Kevin Kelley, Tr. 386). In November, 1974, Richardson employees Michael Wawra and Thomas C. Thomas met with the manager of Security Finance Corporation, a stock loan broker, to find stock lenders for Richardson in order to enable it to cover its short positions. (Plaintiff's Exhibit #5, ¶ 32). Security Finance Corporation soon arranged for several of its clients to lend the securities in their portfolios to Richardson.

Under the terms of the stock loan agreements, lenders were to receive cash payments of not less than 100% of the closing price of the stock on its most recent trading day in exchange for the stock loaned. Such a payment is characterized as the "cash collateral" securing the stock loan. The lender is entitled to retain all profits arising from the use of the cash collateral securing the stock loan as well as all cash and stock dividends paid out by the issuer of the stock. (*Id.* ¶ 36). In order to keep the amount of cash collateral equal to the market value of the stock loaned, both Richardson and the lenders had reciprocal rights to require adjustments in the collateral called "mark-to-the-market" payments. Thus, if the value of the borrowed stock increased, Richardson would have to make a mark-to-the-market payment to the lender; the converse was also true. (*Id.*) The cash collateral necessary for Richardson to obtain and maintain these loans was obtained by creating false order tickets and confirmations which showed the stock borrowings to be stock purchases made by Richardson. (*Id.* ¶ 38). These false documents were attached to the written instructions given by Richardson to WFB for the purpose of making it appear that it was a legitimate

matched trade order between institutions rather than a loan of stock to Richardson (*Id.*). Richardson's employees also concealed these short positions by making false entries on the accounts of several of its customers; fictitious purchases of various stocks were recorded to show that the firm owned the stock it was selling to brokers (*Id.* ¶¶ 30, 84, 86, 87 and Plaintiff's Exhibits 1-4). By December 31, 1974, Richardson had borrowed in excess of $25 million worth of stock from fourteen different institutions (*Id.*, ¶ 34). All of the stocks borrowed in this manner were used to deliver on short sales previously made by Richardson (*Id.*, ¶ 35).

As a result of a rising market in the stocks which Richardson borrowed through Security Finance Corporation, Richardson was unable to meet the required mark-to-the-market payments during March and April, 1975. On April 15, 1975, Richardson advised the Securities and Exchange Commission ("SEC") of its insolvency. The SEC filed a complaint that same day alleging violations of the Exchange Act, and on April 16, 1975, a temporary receiver was appointed to take control of Richardson. As of the latter date, its stock loans were under collateralized by almost $3 million and over $20 million worth of short sales, principally to broker-dealers like the plaintiff, were not covered by stock loans. (Plaintiff's Exhibit 5, ¶ 39). Upon notice of Richardson's insolvency, these broker-dealers were required to buy-in the securities, i.e., purchase them on the open market, to make delivery to customers who had purchased the securities from them on the New York Stock Exchange. (*Id.*) The out-of-pocket cash loss sustained by these broker-dealers—the difference between the price at which Richardson short-sold the stock and the buy-in price to the broker-dealers—was approximately $3.4 million. (*Id.*). Edwards & Hanly sustained a loss of approximately $1.4 million (Plaintiff's Exhibit 15).

Joseph C. Werba, named president of defendant WFSCC in April, 1974, was friendly with a number of Richardson's employees and would see them socially on his frequent business trips to Los Angeles. Richardson had on occasion given Werba and his family generous gifts, including airline tickets to Los Angeles and a vacation weekend on Cape Cod. (Werba, Tr. 45). Commencing in November, 1974, at Richardson's request, Werba advanced funds to Richardson from WFSCC's bank account with the Morgan Guaranty Trust Company ("Morgan Guaranty") in New York. (Werba, Tr. 27-30 & Plaintiff's Exhibit 12). These advances were made on an "interest free" basis. Richardson never told Werba why it needed these advances (*Id.*, Tr. 64), which it used to meet its mark-to-the-market obligations. Werba did not think that the request was unusual because he knew that third-market brokers often had liquidity problems (*Id.*, Tr. 78) and because he had made a similar cash advance previously to another firm (Tr. 64). Werba knew, however, that he had no authority to make these advances without WFB's consent, and he informed neither WFB nor his superiors at WFSCC of them. (*Id.*, Tr. 27, 65).[1] The five separate advances totalled over $1 million, and were repaid except for the final advance of $500,000 made on March 31, 1975 just as Werba left the country on a family vacation. (*Id.*, Tr. 41). On or about April 1st, without Werba's knowledge, WFSCC's vice president Gary Bruno informed Ronald Hillman, a vice president of WFB and a member of WFSCC's board of directors, that the various advances had been made and that the last advance had not been repaid (Bruno, Tr. 101-04). When Werba returned from vacation on the evening of April 7th, Bruno informed him of Richardson's failure to pay. Werba then flew to California to speak to Richardson. In San Francisco, Werba was contacted by E. Alan Holroyde, senior vice

president of WFB, WFSCC board chairman and Hillman's immediate superior, who directed Werba to report to WFB's auditing division to explain his actions. Werba was told that he would be placed on "leave of absence", but that he was permitted to meet with Richardson to attempt to get the advance back. (Werba; Tr. 71, 73). At a meeting in San Francisco with Kevin Kelley, Thomas Richardson and Thomas Thomas of the Richardson firm, Werba was told that Richardson lacked the funds to repay the loan (Kevin Kelley, Tr. 396). Empty-handed, Werba returned to the East Coast on April 12th and did not report to work thereafter. (Werba, Tr. 73).

One of the crucial factual issues in this case is whether Werba knew of Richardson's short-selling scheme. In early December 1974, while on a business trip to Los Angeles, Werba met two Richardson employees, cashier Michael Wawra and Treasurer Thomas C. Thomas, for dinner. Wawra explined to Werba that Richardson had begun to suffer losses on certain trades but that it did not want WFB to know for fear that WFB would terminate its draft line of credit. (Werba, Tr. 17). Thomas and Wawra persuaded Werba to aid them in concealing these trades from WFB by handling them on a "special" basis. The Richardson employees proposed that rather than follow the usual procedure of routing written instructions through WFB in Los Angeles, they would telephone delivery instructions directly to WFSCC in New York.

Several days later, Werba, Wawra and Thomas met at the Playboy Club in Century City, California and the subject of "special trades" was raised once again. At his pre-trial deposition, Thomas claimed that he told Werba that Richardson wanted to establish the "special trades" procedure because it had huge short positions in several stocks and wished to make short sales without WFB's knowledge. (Thomas deposition, pp. 30-31, 56-57).

Thomas was fairly certain that he told Werba of these short positions because although he and Werba were close friends, Thomas felt it necessary to explain why such an extraordinary procedure was necessary (*Id.;* p. 60). Thomas continued to say that he did not think his statements had "registered" with Werba, *i.e.,* that Werba did not quite comprehend what Thomas had told him (*Id.,* p. 62), and that he did not remember Werba making any comment concerning the proposed short sales. (*Id.,* p. 62 and 75). Werba, for his part, flatly denies that Thomas, or any other Richardson employee told him that Richardson was short in the market and desired to make "special trades" to conceal its short positions. (Werba, Tr. 21-22, 59). Contrary to the testimony of one of Richardson's traders, Werba also denies that he was told at the San Francisco meeting during the week of April 7, 1975 that Richardson had been selling short (K. Kelley, Tr. 396; Werba Tr. 72). Werba insists that the sole rationale ever given to him for the "special trades" was the need to keep WFB unaware of the losses it had incurred on certain transactions (Werba Tr. 17). On balance the court does not find Werba's version of these conversations to be credible. The court concludes that Werba was informed in early December, 1974 of Richardson's short positions and its desire to hide them from WFB. The deal was finalized on or about December 10, 1974 when, over dinner with Thomas Richardson and two others, Werba received $2,000 in cash from Thomas Richardson for "helping" him out. (*Id.,* Tr. 23, 60, 77). Soon after, Werba received the money, WFSCC began to handle special trades for Richardson. Werba, of course, told neither WFB's employees nor his superiors at WFSCC what he had done. (*Id.,* Tr. 57, 60, 62). Although Werba originally thought that Richardson intended to make only five or six such trades (*Id.,* Tr. 61), from January through

March, 1975, WFSCC cleared approximately 52 special trades.

Marianna Ianuzzi, a WFSCC employee in her mid-twenties, was in charge of receiving and delivering securities from WFSCC's various Los Angeles accounts, including Richardson. Her duties included speaking to the brokers who, like plaintiff, were carrying out Richardson's trades. (*Id.*, Tr. 32). She was not told what she could or could not say to these brokers with respect to trades. (*Id.*, Tr. 34). Indeed, Werba testified that he had given Ianuzzi "carte blanche" in the handling of the Los Angeles accounts, including Richardson (*Id.*, Tr. 32) and Werba's superiors eventually concluded that he had "removed himself" from his daily supervisory function. (Holroyde, Tr. 457). Werba told her of the "special trades" and told her how to handle them (Werba, Tr. 36), although it doesn't appear that Werba told her that these trades were in fact short sales. She would receive receipt and delivery instructions directly from Richardson. Upon completion of the special trades, she sent informal handwritten confirmation statements to Richardson and retained a copy for WFSCC's files. (*Id.*, Tr. 37).

Gary Bruno, WFSCC's vice president, worked under Joseph Werba and directly supervised the work of Marianna Ianuzzi. In February or March, 1975, Bruno advised Werba that the volume of special trades had gotten too great and that the practice should be stopped. (Bruno, Tr. 99). Werba called Richardson's office and spoke to Thomas, informing him that after May 1, 1975, WFSCC would discontinue handling such trades. (Bruno, Tr. 39). Thus, WFSCC continued the practice of clearing the special trades until Richardson's demise on April 15, 1975.

As early as February, 1975, it became increasingly difficult for Richardson to secure enough stock to cover its short positions. Three of its biggest customers, E.F.

Hutton, B.C. Christopher and North American Equity, informed Richardson that they were buying in their accounts with Richardson and would no longer do any business with it because of its consistently late delivery of stock that it had sold to them. (Wawra Dep., 55-57; Thomas Dep., 46-47). Thomas Richardson decided to increase the volume of short sales made through Edwards & Hanly because, by contrast, that firm had never pressed Richardson as hard to make timely delivery. (John Kelley Dep., 31). Thus, while Richardson placed almost no sale orders through Edwards & Hanly in February, 1975, it sold large amounts of stock through that account thereafter. Commencing on or about March 3, 1975 and continuing until April 7, 1975, Richardson sold 23,000 shares of Digital Equipment Corporation, 9,500 shares of E.I. duPont & de Nemours & Co., 2,600 shares of Fairchild Camera Co., 17,500 shares of Halliburton Corp. and 18,500 shares of Texas Instrument Corp. in its cash account with Edwards & Hanly. Virtually all of these sales were short sales. (Defendant's Exhibit A).

Richardson's increasing inability to deliver sold securities promptly created problems for WFSCC and Marianna Ianuzzi. Brokers who were anxious to secure delivery in the face of a rising market began to call her to find when delivery would be made. She, in turn, called Richardson to determine the reason for the delay. At his pre-trial deposition, Richardson's cashier Michael Wawra testified that there came a time when, after giving her many false excuses for late delivery, he finally broke down and told Ianuzzi that certain trades were short sales. Wawra's recollection of the circumstances under which he told her of the practice was hazy. At first, Wawra stated that he remembered one occasion in February or March 1975, during a period when the market was rising and he could not borrow that he had told her that a given trade

was short (Wawra Dep., 32-33). Wawra subsequently testified that he originally told her of the shorts in January at a time when he was physically ill. (Wawra, Dep. 73-4). Wawra then said he recalled between two and five such conversations, and finally, between three and seven such conversations, about specific trades (*Id.*, Dep. 85-7, 93). Wawra admitted, however, that he continued to give excuses to Ianuzzi until the very last day and would lie to her about the lateness of various trades (*Id.*, Dep. 77, 93-4). Joseph Werba claims to remember that in July, 1975, following the dismissal of Ianuzzi and himself by WFSCC, Ianuzzi said that she knew that certain sales were short sales and that she assumed Werba knew as well.[2] (Werba, Tr. 46). When pressed, however, Werba admitted that he really could not remember what she had said about short sales. (*Id.*, Tr. 48).

Wawra and other Richardson employees were similarly successful at keeping Edwards & Hanly at bay. Richardson had always been late in delivering securities to Edwards and Hanly. The standard sale contract between brokers in the industry required delivery within five business days in a delivery versus payment/receipt versus payment account (Defendant's Exhibit A). Through March, 1975, Edwards and Hanly tolerated delays by Richardson of two to three months in some extreme cases, and delays of two to three weeks as a regular practice. (*Id.*) There was testimony at trial to the effect that, as a matter of trade custom, brokers often tolerated delays of three or four weeks (Monigan, Tr. 575); lengthier delays were expected from third-market brokers than from retail customers because third-market brokers, in turn, often had to wait for delivery from their institutional customers. (Foote, Tr. 326-27). No rule or practice precluded Edwards & Hanly from buying in an account once the date on which delivery was due had passed. (Peake, Tr.

527). Nevertheless, Edwards & Hanly had an obvious disincentive to buy in the account because the account generated substantial brokerage commissions. (Edwards, Tr. 501). Thus, when Richardson went under on April 15, 1975, Edwards & Hanly was required to buy-in over thirty failed trades, almost two thirds of which were at least three weeks past due. (Defendants' Exhibit A). Almost ninety per cent of the short sales which plaintiff had to buy-in were made by Richardson in March, 1975. (*Id.*)

The registered representative at Edwards & Hanly in charge of the Richardson account, Dominic Gulemi,[3] testified that the account did not begin to encounter any problems with late deliveries until the latter part of 1974. Informed by the firm's margin clerk that Richardson had two very late outstanding deliveries, Gulemi contacted Wawra and delivery of the stock followed soon after. (Gulemi, Tr. 194-96).[4] Understandably, Edwards & Hanly personnel did not become truly concerned with Richardson's late deliveries until the last week of March, 1975 when Edwards & Hanly transferred the clearing functions for its retail accounts to another firm and retained clearing functions over only institutional clients. (Edwards, Tr. 139; Foote, Tr. 342). Managing partner Bert Edwards, concerned with the large credit balance that the firm was required to carry on its books due to Richardson's failure to deliver,[5] sought assurances from his subordinates that Richardson would make good on delivery. In late March, however, the account was not "at risk" for a substantial sum; the difference between the price at which Richardson sold undelivered stock and its market price on a given day hovered between $100,000 and $200,000. Edwards determined that buying in the account was not yet necessary. (Defendant's Exhibit B and Edwards, Tr. 144).

On April 7, 1975, an Edwards & Hanly margin clerk named Mulholland calculated that Richardson owed the

plaintiff over $7 million in stock and informed Gulemi of the situation. (Gulemi, Tr. 205). Gulemi immediately contacted Wawra, who falsely attributed the delay to the failure of Richardson's clients to deliver its stock and promised delivery within a week. (*Id.*, p. 206). Gulemi then contacted O'Hare, manager of the Huntington Office, and for the first time suggested that a principal of the Edwards & Hanly firm contact Richardson and demand delivery (*Id.* Tr. 208, 237). O'Hare subsequently spoke to Wawra, but found him to be evasive (O'Hare, Tr. 261). At no time did any Richardson employee tell any Edwards & Hanly employee that any sales made by Richardson were short sales. From April 7th onward, plaintiff's net risk position on the Richardson account increased substantially due to a rapidly increasing market. The total net risk to Edwards & Hanly moved from approximately $200,000 on the 7th, to over $450,000 on the 9th, to over $1 million on the 14th and $1.3 million on the 15th. (Defendant's Exhibit B).

Defendant's expert witness Francis Monigan, then an assistant vice president with the firm of Dean Witter & Co., testified that in his opinion, by February, 1975, the reasonably prudent broker would no longer maintain a good faith belief that Richardson had a long position in the stocks it sold. (Tr. 569). In his opinion, the reasonably prudent broker would have commenced buying-in the account on March 7, when the net risk to Edwards & Hanly was over $30,000 and two Richardson sales of Halliburton Co. stock had failed. (Tr. 570-71). Another defendant's expert, Junius Peake, took an even more cautious approach to Richardson's late deliveries and testified that by late November, 1974 a reasonably prudent broker could no longer believe in good faith that Richardson was selling long. (Tr. 515-22). By that date, approximately 10,000 shares of Halliburton, 2,000 shares of DuPont and 5,000

shares of Schlumberger stock were owing to plaintiff (Defendant's Exhibit B). Peake felt that Richardson's repeated lateness of delivery was inconsistent with its role as a third market broker because the buyer on a matched trade generally wants his stock promptly. (Peake, Tr. 518-19).

Edwards & Hanly made persistent inquiries of WFSCC personnel in an effort to secure delivery of stock. John Stokes, a back office employee, called Marianna Ianuzzi once a day during the last two weeks in March. Each conversation followed the same pattern: he would ask her if Edwards & Hanly would be receiving any securities that day for Richardson's account; she would say she had not received the stocks, but promised to contact him when she received them (Stokes, Tr. 374-75). Plaintiff's head cashier Arthur Foote inquired after various late items in late March and early April (Foote Tr. 305-08), and again on April 15th (Foote, Tr. 312). On the latter occasion, Ianuzzi informed him that she had several open items but was expecting the delivery of some Schlumberger Corp. stock, which stock eventually cleared. On April 14, 1975, and again on the afternoon of April 15th, Hugh O'Hare, manager of plaintiff's Huntington office, called and spoke to Ianuzzi to ask if she had instructions to deliver specific securities. She indicated that she had instructions but, as yet, no stock to deliver. (O'Hare, Tr. 262-64, 287). Similar conversations ensued between Ianuzzi and Robert Della Vecchia, plaintiff's head cashier in the New York office in March, 1975 with respect to late deliveries generally. (Della Vecchia, Tr. 357-58). In each of these conversations, Ianuzzi stated that she had no stock to deliver, but that she would call plaintiff when she received it. In none of these conversations did she state that she either knew or suspected Richardson was selling short. In early April, Della Vecchia spoke to Anthony Sorrentino, a stock loan

officer employed by another firm, who told him that he had heard a rumor that Richardson was in bad financial condition and may have been short stock (Della Vecchia, Tr. 359-61). On or about April 10, Della Vecchia called Ianuzzi to inquire about the delivery of stock. He mentioned the rumor to her but she dismissed it as being "just a rumor" and stated that she felt plaintiff would get its stock. (*Id.*, Tr. 360).

WFSCC's personnel in New York were subject to the control of certain WFB officers, headquartered in San Francisco, who also served on WFSCC's board of directors.[6] A detailed procedural manual served as a guide for WFSCC's employees (Defendant's Exhibit I). It authorized WFSCC, as WFB's agent, to act only upon the direct instructions of WFB's securities industry department as specified on both securities receipt forms and securities delivery forms. WFSCC could accept delivery against payment only if it had a securities receipt form from WFB containing the same information as the delivery bill which accompanied securities delivered in by a broker-dealer. If the information differed or if WFSCC lacked a receipt form, it could not accept delivery against payment without WFB confirmation. Because of the time lag between New York and California, WFSCC was permitted to investigate such discrepancies by contacting WFB's customer, but it was never authorized to rely on customer advice without receiving WFB confirmation. Without such confirmation, WFSCC was obligated to reject the delivery and return the securities to the delivering party. Each morning, WFSCC would wire WFB information regarding all securities received that day. If the delivery of securities to WFSCC was in accord with a receipt form in its possession the wire would serve as a basis for WFB to fund WFSCC's bank account in New York. If WFSCC received a delivery for which it had no form or on which

the information on the receipt form differed from that on the delivery bill, WFB would investigate the discrepancy.

Monthly meetings of WFB's securities industry department were held in California and WFSCC representatives, generally either Werba or Bruno were required to attend and report on WFSCC's business (Holroyde, Tr. 437). In 1974, WFB learned that Werba had violated the procedures set forth above by accepting changes in delivery instructions from brokers directly rather than waiting for WFB's instructions. (*Id.*, 438-39). At a meeting of the securities industry department, WFB's policy of requiring WFSCC to act solely at WFB's direction was reaffirmed. (*Id.*)

WFSCC's monetary operations were also subject to some controls. For trades on which WFSCC had instructions, it would issue its check for the securities in clearing house funds available on the next day. To insure that WFSCC had sufficient funds in its account at Morgan Guaranty to cover checks issued that day, WFB would wire, in immediately available federal funds, the exact amount to the Morgan Guaranty account necessary to cover the checks issued for securities received in that day. (Holroyde, Tr. 450).

Because WFSCC's account was funded with immediately available federal funds but the checks that were drawn on the account were paid in clearing house funds available the next day, there was a continual lag in WFSCC's account. This lag, or "float", was intentionally designed to provide WFSCC with an investment opportunity. The continual lag was used for investment in commercial paper and certificates of deposit (Holroyde, Tr. 447). It was this lag which created funds from which Werba made unauthorized advances to Richardson.

Each day WFSCC would prepare a money control sheet for all financial transactions through its Morgan Guaranty

account. These sheets provided a basis for determining the amount available for overnight investment. They were reconciled weekly to the Morgan Guaranty statement by WFSCC employees and were audited on a yearly basis by WFSCC's auditors. (*Id.*, Tr. 452-53). The daily money sheets were sent to WFB, but not to the directors of WFSCC working in San Francisco who were charged with supervision of WFSCC. (*Id.*, Tr. 453-6). WFSCC's directors in San Francisco received monthly statements from Morgan but those statements did not identify individual deposits and withdrawals from the Morgan account. (Tr. 447-48).

Discussion

The complaint alleges that WFSCC is liable to plaintiff either as a direct participant in Richardson's scheme or as an aider and abettor to Richardson and others. (Complaint, ¶ 23). It is clear, however, that the allegedly fraudulent sales were between Richardson and the plaintiff. The true gist of Edwards & Hanly's allegations is that WFSCC's employees aided Richardson in the commission of fraud; if WFSCC is liable at all, it is under theories of secondary liability.

In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), the Supreme Court explicitly refused to decide whether § 10(b) and Rule 10b-5 may give rise to aiding and abetting liability. *Id.* at 192 n. 7. Since *Hochfelder,* however, the Court of Appeals for this Circuit has held that these provisions do permit the imposition of aiding and abetting liability. *Rolf* v. *Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 44 (2d Cir. 1978); *Hirsch* v. *DuPont,* 553 F.2d 750, 759 (2d Cir. 1977). This court's initial task, therefore, is to evaluate the conduct of WFSCC's employees Werba

and Ianuzzi to determine whether either of them may be said to have aided and abetted a § 10(b) violation.

The elements that a plaintiff must prove to impose liability upon an aider and abettor are well established: (1) that the primary party, here Richardson, as distinguished from the secondary aiding and abetting party, committed a securities law violation; (2) that the aider and abettor knew of the violation; and (3) that the aider and abettor substantially assisted in effecting the violation. *Rolf* v. *Blyth Eastman Dillon & Co., supra,* 570 F.2d at 47-48; *SEC* v. *Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975); *cf. Rochez Bros. Inc.* v. *Rhoades,* 527 F.2d 880, 886 (3d Cir. 1975); *Landy* v. *Federal Deposit Ins. Co.,* 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974) (proof of "wrongful act" by primary wrongdoer suffices for first element).

The first requirement of the test poses little difficulty in the instant case. Although selling short does not violate § 10(b) in and of itself, the seller's willful failure to disclose his short position is another matter. The record clearly warrants a finding that Richardson defrauded Edwards & Hanly within the meaning of § 10(b) and Rule 10b-5.[7] Plaintiff has shown all of the elements of an implied right of action under § 10(b): a willful misstatement or omission of a material fact which caused him injury in connection with his purchase or sale of a security. *See Santa Fe Industries Inc.* v. *Green,* 430 U.S. 462, 474 n.14 (1977) (material misstatement or omission required); *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 197 (knowing or intentional misconduct required); *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 730-731 (1975) (plaintiff must be purchaser or seller of securities). Thomas Richardson instructed his employees to conceal the fact that their firm was selling short; the willfulness of the omission is clear. Moreover, whether or not the firm possessed

the stock it sold was an "omitted fact [which] would have assumed actual significance in the deliberations of the reasonable [purchaser];" the omission was thus "material." *TSC Indus., Inc.* v. *Northway, Inc.,* 426 U.S. 438, 449 (1976). Finally, Richardson's actions obviously "caused" plaintiff's injury. Where, as here, the defendant's conduct involves primarily a failure to disclose "positive proof of reliance is not a prerequisite to recovery." *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 153 (1975). "[T]he proper test to determine whether causation in fact has been established in a non-disclosure case is 'whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.'" *Shapiro* v. *Merrill Lynch Pierce, Fenner & Smith, Inc.,* 495 F.2d 228, 239 (2d Cir. 1970) (citations omitted).[8]

The second requirement for establishing an aiding and abetting violation is the secondary party's knowledge of the primary violator's fraud. *Hochfelder's* basic holding that scienter is an element of the § 10(b) cause of action, "also establishes the standard for aiding and abetting liability." *Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 44. One of the questions left open by the *Hochfelder* decision was whether "recklessness" satisfies that standard. The Second Circuit partially answered this question in *Rolf,* by holding that at least in situations in which the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness will suffice. 570 F.2d at 44. Although the Court of Appeals did not reach the question of whether recklessness satisfies the scienter requirement where the alleged aider and abettor does not owe a duty of disclosure and loyalty to the defrauded party, *id.* at 44 n.9, its opinion intimates strongly that "recklessness" may constitute scienter even in the absence of a fiduciary relationship.[9] Thus, even though banks and stock transfer agents have

no special duty of disclosure, *see Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84, 97 & n.29 (5th Cir. 1975); *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151-52 (1972), this court will analyze the actions of WFSCC's employees under a "recklessness" standard.

Evidence of knowledge may be shown circumstantially, but the proof must demonstrate either actual awareness of, or the reckless failure to discover, the primary violator's fraudulent scheme. *Rolf* v. *Blyth, Eastman, Dillon & Co., supra,* 570 F.2d at 47; *Woodward* v. *Metro Bank of Dallas, supra,* 522 F.2d at 96. "[K]nowledge of the fraud, and not merely the undisclosed material facts, is indispensable." *Hirsch* v. *duPont, supra,* 553 F.2d at 759. *Accord, Murphy* v. *McDonnell & Co.,* 553 F.2d 292, 295 (2d Cir. 1977).

This court has already concluded that WFSCC's president, Joseph Werba, knew that the reason Richardson wished to institute "special trades" was its massive short stock position. Given Werba's long experience in the securities field and his knowledge of Richardson's business, the court further concludes that Werba knew that Richardson was defrauding broker-dealers by failing to disclose its short position or, at least, recklessly failed to discover Richardson's fraud. Even if Richardson's employees did not expressly tell Werba that they planned to disguise their trades as "long", Werba must have known that this was their intent. Affiliated with WFSCC from its inception, Werba knew that Richardson's accounts with various brokerage firms were cash delivery-versus-payment accounts and, should have known that short sales could not legally be made in such accounts. Even if Werba thought, at the outset, that Richardson fully intended to disclose its short positions to its purchasers, Werba recklessly failed to discover that Richardson had not done so. Having established a procedure designed to facilitate Rich-

ardson's short-selling, Werba persisted in the delegation of all responsibility over the Richardson account to Ianuzzi. Thus, Werba effectively insulated himself from broker-dealer complaints concerning late delivery which, given his knowledge of Richardson's short trading, would have put him on notice that the broker-dealers were the victims of fraud. Werba must thus be charged with knowing that the real nature of Richardson's trades was hidden not only from WFB, but also from the broker-dealers to whom Richardson short sold stock.

As to Marianna Ianuzzi's state of mind, however, the sole testimony implicating her is that of Michael Wawra, Richardson's cashier. Wawra could not recall whether he had told Ianuzzi of the short sales only once or as many as seven times. Wawra's conflicting versions of what he told Ianuzzi and how often he told her, render his credibility suspect. Even if the court were to find that at some point in time Wawra told Ianuzzi that certain of the sales were shorts, it is by no means clear that Ianuzzi was aware of the pervasive nature of the scheme. Wawra admits that, until the very end, he continued to give Ianuzzi the very same excuses for late delivery that he offered to Gulemi, Edwards & Hanly's representative. Until Richardson's demise, therefore, Ianuzzi remained as much a target of its fraudulent assurances as was Gulemi. Ianuzzi undoubtedly knew that the Richardson trades were not being handled in the conventional manner, and that Richardson was late in its deliveries. These facts, in and of themselves, however, are insufficient to show either that Ianuzzi actually knew the trades were short or that Richardson's short selling was so obvious that she must have known of it.

The third and final element of aiding and abetting liability is "substantial assistance" of the primary violation. The nature of the assistance rendered by the alleged

aider and abettor relates to the knowledge element where, as here, there was no independent duty to disclose. *Woodward* v. *Metro Bank of Dallas, supra,* 522 F.2d at 97; *H.L. Federman & Co.* v. *Greenburg,* 405 F. Supp. 1332, 1337 (S.D.N.Y. 1975).

> In a case combining silence/inaction with affirmative assistance, the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved. If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities laws. Conversely, if the method or transaction is atypical or lacks business justification it may be possible to infer the knowledge for aiding and abetting liability. In any case, the assistance must be substantial before liability can be imposed under 10b-5.

Woodward v. *Metro Bank of Dallas,* 522 F.2d at 97. As to Ianuzzi's conduct, the evidence reveals nothing more than "the daily grist of the mill"; it was her responsibility to discuss outstanding deliveries with broker-dealers. Absent clearer proof of conscious intent to violate the securities laws, her mere failure to disclose what she knew of Richardson's actions is not actionable. *Id.; SEC* v. *Coffey, supra,* 493 F.2d at 1317. Having found that Werba knew of the Richardson scheme, however, the court has little trouble finding that Werba "substantially assisted" Richardson in perpetrating its fraud. Werba's unauthorized actions—advancement of interest free funds to Richardson and processing its trades without WFB's approval—hardly constituted typical business transactions. Moreover, Werba's acts were a "substantial causal factor in the [perpetration] of [Richardson's] fraud and in the cumulation of [Edwards & Hanly's] losses." *Rolf* v. *Blyth,*

Eastman Dillon & Co., 570 F.2d at 48; *Landy* v. *Federal Deposit Ins. Co., supra,* 486 F.2d at 163. Had Werba not acquiesced in the "special trade" arrangement and advanced the interest-free funds, Richardson would not have been able to conceal or to finance its massive short sale speculation. After considering plaintiff's proof in light of the established elements of the aiding and abetting theory, the court concludes that Joseph Werba aided and abetted Richardson's fraudulent scheme.[10]

Given Werba's complicity in the Richardson scheme the court must next determine whether liability may be imputed to WFSCC. The two principal sources of vicarious liability asserted against employers of those who commit or participate in securities fraud are the common law doctrine of respondeat superior and § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), which states:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

There is some disagreement among the circuits, *see Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 48 n.17 and cases cited therein, over the extent to which § 20(a) precludes the availability of common law theories of agency in this context. The distinction is "not entirely esoteric" because under the statute, unlike at common law, there is a defense of "good faith." *Plunkett* v. *Dominick & Dominick,* 414 F. Supp. 885, 887 (D. Conn. 1976).[11]

The tension between common law agency principles and § 20(a) has not been fully resolved in this Circuit. In

SEC v. *Management Dynamics, Inc.,* 515 F.2d 801 (2d Cir. 1975), the Court of Appeals held that at least with respect to SEC enforcement actions, § 20(a) was not intended as the sole measure of employee liability. *Id.* at 812. The court analyzed the legislative history of the section and determined that Congress did not intend § 20(a) to supplant common law agency principles. *Id.* On the facts before it, the court found that a brokerage firm whose vice president in charge of trading acted with apparent authority was subject to an SEC injunction for his fraudulent activities. *Id.* at 813. The court, however, carefully limited the scope of its holding:

> We need not decide today whether the entire corpus of agency law is to be imported into the securities acts for all purposes . . . [W]e intimate no view as to other cases which may involve lesser employees, actions for damages, other agency principles or respondeat superior, which may be broader than the apparent authority involved here. Such cases may involve entirely different policy considerations that are best consigned to future resolution.

Id. Subsequently in *SEC* v. *Geon Industries, Inc.,* 531 F.2d 39 (2d Cir. 1976) the court declined to extend *Management Dynamics* to require the imposition of respondeat superior liability upon a brokerage firm whose registered representative had violated the securities laws. The court held that, absent a showing of inadequate supervision by the firm, respondeat superior liability would not lie. *Id.* at 54-56. As in *Management Dynamics,* however, the court made clear that it "intimate[d] no view as to cases with different facts." *Id.* at 55.

On the facts of this case, this court need not resolve "the rather thorny controlling person-respondeat superior issue." *Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570

F.2d at 48 n.19. Under either theory, WFSCC may be found liable for Werba's acts. At common law, WFSCC is liable as a principal for the tortious acts of Werba, its agent, so long as those acts are found to be "within the scope of employment." *Fey* v. *Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974); *Lewis* v. *Walston & Co.*, 487 F.2d 617, 623-24 (5th Cir. 1973). That Werba's actions were unauthorized is not determinative of whether they were taken "within the scope of employment." *Lewis* v. *Walston, supra.* The Restatement (Second) of Agency defines "the scope of employment" as follows:

§ 229. Kind of Conduct within Scope of Employment

(1) To be within the scope of the employment, conduct must be of the same general nature as that authorized, or incidental to the conduct authorized.

(2) In determining whether or not the conduct, although not authorized, is nevertheless so similar to or incidental to the conduct authorized as to be within the scope of employment, the following matters of fact are to be considered:

(a) whether or not the act is one commonly done by such servants;

(b) the time, place and purpose of the act;

(c) the previous relations between the master and the servant;

(d) the extent to which the business of the master is apportioned between different servants;

(e) whether or not the act is outside the enterprise of the master or, if within the enterprise, has not been entrusted to any servant;

(f) whether or not the master has reason to expect that such an act will be done;

(g) the similarity in quality of the act done to the act authorized;

(h) whether or not the instrumentality by which the harm is done has been furnished by the master to the servant;

(i) the extent of departure from the normal method of accomplishing an authorized result; and

(j) whether or not the act is seriously criminal.

Insofar as Werba's institution of the "special trade" arrangement concerned the processing of Richardson's trades generally, his conduct was "within the enterprise" of WFSCC and "similar in quality" to the acts he was routinely authorized to perform. As to both the special trades and the furnishing of the interest-free advances, Werba clearly used his position as WFSCC's president, including his access to and control over WFSCC's bank account and WFSCC's employees, to provide these services to Richardson. To this extent, the "instrumentality by which the harm [was] done [was] furnished" by WFSCC to Werba. As to Werba's purpose in providing these services to Richardson, his principal motive was to benefit both Richardson and himself, rather than WFSCC, his employer. It seems likely, however, that Werba also sought to maintain Richardson's good will and preserve a profitable account for WFB, WFSCC's parent. That WFSCC received no direct financial benefit from Werba's actions is not of controlling importance. *Lewis* v. *Walston, supra,* 487 F.2d at 624. In sum, Werba's unauthorized conduct was sufficiently similar to his authorized duties to be "within the scope of his employment" and WFSCC would incur liability under common law agency theories.

Under Section 20(a), WFSCC fares no better. It is clear that WFSCC "controlled" Werba within the mean-

ing of this section. "The issue of 'control' is a complex fact question which requires an examination of the relationships of the various alleged 'controlling persons' to the person or entity which [is] alleged to have violated the Act." *Sun First National Bank of Orlando* v. *Miller,* 77 F.R.D. 430, 439 (S.D.N.Y. 1978) (citation omitted). There is no statutory definition of control, but the courts "have given heavy consideration to the power or potential power to influence and control the activities of a person as opposed to the actual exercise of power." *Rochez Bros., Inc.* v. *Rhoades, supra,* 527 F.2d at 890-91. Although the cases have recognized that controlling persons cannot be expected to exercise the same degree of supervision over corporation presidents as over lesser employees, *see, e.g., Moerman* v. *Zipco, Inc.,* 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff'd per curiam,* 422 F.2d 871 (2d Cir. 1970). Werba was accountable to WFSCC's chairman in the corporation hierarchy, reported to him on a monthly basis at securities industry department meetings, had been reprimanded by him previously for acting on a broker's delivery instructions without WFSCC confirmation and was ultimately fired by him for his role in the events that precipitated this lawsuit.

The burden thus falls upon WFSCC to prove its "good faith." *Kravitz* v. *Pressman, Frohlich, & Frost, Inc.,* 447 F. Supp. 203, 212 (D. Mass. 1978); *Gordon* v. *Burr,* 366 F. Supp. 156 (S.D.N.Y. 1973), *modified on other grounds,* 506 F.2d 1080 (2d Cir. 1974). Only those "who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons" *Lanza* v. *Drexel Co.,* 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc), are meant to come within the ambit of § 20(a). *Accord, Rochez Bros.* v. *Rhoades, supra,* 527 F.2d at 890; *Gordon* v. *Burr,* 506 F.2d 1080, 1085-86 (2d Cir. 1974). "Knowledge is the key to the assertion of good faith. . . . Those who neither know or

have reason to know of an agent's misdeeds are not liable as control persons." *Ingenito* v. *Bermec Corp.,* 441 F. Supp. 525, 533 (S.D.N.Y. 1977). If the fraud went undiscovered because of the controlling person's willful or reckless disregard, the good faith defense is unavailable. *Lanza* v. *Drexel & Co., supra,* 479 F.2d at 1306. Constructive knowledge may be shown if inadequate precautionary mechanisms were established to prevent the fraud. *Barthe* v. *Rizzo,* 384 F. Supp. 1063, 1069 (S.D.N.Y. 1974).

There is no question that Werba's superiors did not know of Richardson's short sales until its collapse and, moreover, did not even know of Werba's unauthorized action until WFSCC vice president Gary Bruno alerted them to it on or about April 1, 1975. The case thus turns upon the adequacy of the company's supervision of Werba. On the record before it, the court concludes that WFSCC's precautionary mechanisms were inadequate.

As discussed previously, if WFSCC did not receive securities receipt and delivery forms on a given delivery, or if the information on the forms did not correspond to the delivery bill accompanying the stock, WFSCC was supposed to wire WFB's securities industry department for confirmation. Until and unless confirmation was received, WFSCC was not to accept delivery. WFSCC was further required to wire WFB information concerning all securities received each morning. If delivery was in accord with a securities receipt form in WFSCC's possession, the wire served as a basis for WFB to fund WFSCC's bank account with sufficient funds to make the "purchase" from the broker making delivery. If delivery was made for which WFSCC had no receipt form, WFB would investigate and, if possible, confirm the trade. On deliveries for which there was a receipt form, or on which WFB sent confirmation, WFSCC was to send a wire on the following day indi-

cating that the stock had been redelivered to the purchasing broker pursuant to a securities receipt form.

As is evident from this description of WFSCC's operations, however, there was no safeguard whatsoever against WFSCC's handling of trades without the requisite forms or confirmations. Nothing in the procedure outlined served to notify WFSCC's directors whether delivery had been accepted on stocks for which no instructons had been sent. In light of Werba's prior history of contacting brokerage firms directly and acting on their instructions without WFB's confirmation, WFSCC's directors were obviously aware of the need for some independent verification that Werba and the WFSCC staff acted only pursuant to WFB's instructions. The monthly meetings at which Werba was occasionally reminded of his responsibility in this regard were not a sufficient safeguard against his failure to comply.

WFSCC's controls over Werba's monetary powers were similarly deficient. To be sure, there was a legitimate business purpose for generating float in WFSCC's bank account—investment in the money market. It appears, however, that Werba's superiors at WFSCC did not receive the company's daily money control sheets or, better still, an itemized bank statement from Morgan Guaranty indicating how that float was invested. The full extent of their supervision of the bank account's activity consisted of the review of monthly statements from Morgan which failed to itemize deposits and withdrawals and the routine yearly audit of WFSCC's books. This inadequate supervision of Werba's investment pattern enabled him to loan Richardson over $1 million interest free, between November, 1974 and March, 1975 without his superior's knowledge.

WFSCC has, in short, failed to sustain its burden of proving "good faith." Even if § 20(a) ought to govern WFSCC's conduct instead of common law agency doc-

trines, the court finds WFSCC to be derivatively liable for Werba's aiding and abetting of Richardson's fraudulent conduct.

WFSCC has raised several affirmative defenses which it claims must bar, or at least limit, the extent of Edwards & Hanly's recovery. WFSCC's principal contention is that Edwards & Hanly failed to exercise "due diligence" in the handling of the Richardson account and that it either knew, or should have known, of Richardson's short-selling scheme.[12] There is not a shred of evidence, however, that any Edwards & Hanly employee actually knew of Richardson's scheme. Dominic Gulemi, the plaintiff's registered representative in charge of the Richardson account, maintained close personal relationships with several Richardson employees, but there is simply nothing in the record to suggest that Gulemi was privy to the scheme. The real issue presented is whether Edwards & Hanly should have known of it.

WFSCC points to various factors which it claims should have alerted Edwards & Hanly to Richardson's short-selling. From November, 1974 through April 15, 1975, sell orders predominated greatly over buy orders. This high concentration of sell orders, WFSCC argues, was inconsistent with Richardson's business as a "third market broker"; it was highly unlikely that so many of Richardson's matched trades would be uneven, thereby requiring it to dispose of overages. Almost all of the deliveries of stock on these sell orders were made after the due date. Moreover, in March, 1975, Edwards & Hanly accepted a large number of sell orders for large blocks of stock when prior sell orders for the same stock had been executed shortly before and some of these prior orders were already in a "fail" position.

The court concludes, however, that the activity in the Richardson account was not so unusual as to charge

plaintiff with a lack of diligence in discovering the fraud. Although Richardson was continually late in making deliveries, several witnesses, including defendant's expert Monigan, testified that delays of over three weeks were customarily tolerated in the industry. Only a small percentage of the Richardson sales orders in the six stocks that failed were over three weeks late. Except for one egregiously late fail in Texas Instruments stock, the oldest sale which Edwards & Hanly was eventually required to buy in settled on March 10, 1975—35 days before the Richardson insolvency. Nor was the high concentration of sale orders in March, 1975 necessarily indicative of short-selling. The account had been similarly active in November and December 1974 and only a small percentage of the deliveries made during those months were uncharacteristically late by industry standards. It is significant to note, moreover, that Richardson was able to deliver a large block of stock to plaintiff as late as April 7, 1975—just one week prior to its collapse. (Defendant's Exhibit C). In light of the long standing relationship between plaintiff's representative and Richardson, the continual assurances by Richardson to plaintiff's employees in March and April 1975, and the history of late deliveries in the account, the court concludes that it was not unreasonable for plaintiff to believe that Richardson was executing legitimate matched trades. In this regard, the court specifically discredits the testimony of both of defendant's expert witnesses. The court finds that the activity of the Richardson account was not such as to put Edwards & Hanly on notice of Richardson's short selling.

Defendant also contends that Edwards & Hanly violated Regulation T, 12 C.F.R. § 220.4, in its handling of the Richardson account and that this, too, should bar recovery. Regulation T, promulgated by the Board of Governors of the Federal Reserve System pursuant to § 7 of the Exchange Act, 15 U.S.C. § 7g,[13] states in pertinent part:

> (c) Special Cash Account
>
> (1) In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may:
>
> * * *
>
> (ii) Sell any security for, or purchase security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

12 C.F.R. § 22.4(c)(1)(ii). This portion of Regulation T imposes an obligation upon a broker to have a "good faith" belief at the time it executes a sell order for a cash account that the customer (here, Richardson) will promptly deliver the stock to the broker. *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166, 1175 (8th Cir. 1972). This obligation has been construed to be a continuing one; the initial good faith acceptance of a sell order is not complete compliance with the rule and the brokers with knowledge of margin requirements and the apparent that the stock will not be delivered promptly. *Id.* at 1176. The term "promptly" does not indicate any fixed time limit for delivery; if, upon inquiry, the broker ascertains that slow delivery is unavoidable and out of his customer's control, "he may indulge a reasonable delay commensurate with the circumstances without any impairment of good faith." *Id.* at 1177.

In *Pearlstein* v. *Scudder & German,* 429 F.2d 1136, 1140-41 (2d Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971) (*"Pearlstein I"*), the Court of Appeals for this Circuit

recognized an implied right of action under § 7 and Regulation T on behalf of a customer whose brokerage firm failed to comply therewith. The portion of Regulation T involved in *Pearlstein I,* not at issue here, required a broker to liquidate a transaction if a customer purchased a security in a special cash account and failed to make full cash payment within seven days, 12 C.F.R. § 220.4 (c)(2). The court reasoned that the securities laws charged brokers with knowledge of margin requirements and the duty to obey them. Although it noted that Congress's purpose in enacting § 7 was to protect the economy as a whole from market speculation rather than to protect individual investors from their own inability to pay, the court determined that private actions by investors were an effective means of protecting the over-all economy. 429 F.2d at 1140-41. The continuing vitality of this implied cause of action has recently been questioned by both the Court of Appeals, *Pearlstein* v. *Scudder & German,* 527 F.2d 1141, 1145 (2d Cir. 1975) (*"Pearlstein II"*) and several judges of this district. *See, e.g., Newman* v. *Pershing & Co.,* 412 F. Supp. 463, 468 n.7 (S.D.N.Y. 1975); *Bell* v. *Winer & Co.,* 392 F. Supp. 646, 652-54 (S.D.N.Y. 1975). Subsequent to *Pearlstein I,* Congress enacted § 75(f) of the Exchange Act and the Federal Reserve Board promulgated Regulation X, 12 C.F.R. § 224, making it unlawful to obtain credit in violation of margin requirements. "The apparent effect of these new enactments was to make an investor equally responsible with a broker for observance of margin requirements." *Newman* v. *Pershing & Co., supra,* 412 F. Supp. at 468 n.7.

WFSCC has brought only one case to this court's attention in which a defendant sought, as here, to raise a broker's violation of Regulation T as a *defense* to a 10b-5 claim by the broker rather than as a basis for affirmative relief against the broker as in *Pearlstein I. See Grimes,*

Hooper, & Messer, Inc. v. *Pierce,* Fed. Sec. L. Rep. ¶ 95,341 (C.D. Cal. 1973), *aff'd per curiam,* 519 F.2d 1089 (9th Cir. 1975). Although the *Grimes* court indicated that a Regulation T violation would bar a broker from recovering against a bank as an aider and abettor in a fraudulent short-selling scheme, this legal conclusion was not necessary for the disposition of the case because the court implicitly found that the broker failed to show that the bank had knowledge of the fraud. *See* Fed. Sec. L. Rep. ¶ 95,341, at 98,691. In any event *Grimes* was decided before Congress's enactment of § 7(f) and the promulgation of Regulation X. The doubtful status of the implied right of action under Regulation T certainly weakens WFSCC's contention that Regulation T violations may be interposed as a defense to fraud.[14]

Even if Regulation T may be employed in this manner, the court finds that Edwards & Hanly did not violate its terms. The existence of "good faith" is to be judged on the totality of circumstances. The usual practice in the industry was to allow brokers more time to effect deliveries than was accorded retail customers. Delays of over three weeks were tolerated because all concerned realized that brokers act as middlemen and must often await delivery from their customers as well as complete required paper work. Only a small percentage of the failed trades were more than three weeks late in delivery. Moreover, this is not a case in which the broker made no inquiry concerning the reasons for delay. In late March and early April 1975, Edwards & Hanly made repeated inquiries of both Richardson and WFSCC about late deliveries. Considering the industry's usual toleration of late deliveries, the court is not convinced that Richardson's excuses for delay were anything less than credible to plaintiff. Nor were the number of sales made in March substantially greater than the number made in November and December upon which

delivery, though late, was made. In short, the court finds no violation of Regulation T at the time any of the sale orders were executed or at any time thereafter.[15]

Damages

Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a), limits recovery in securities law actions to "actual damages." The appropriate measure of damages for the violation proven in this case is the difference between the price at which Richardson sold the securities through plaintiff and the price plaintiff was required to pay to buy in the securities, including dividend charges $1,441,122.45. (Plaintiff's Exhibit 15). Defendant does not dispute this amount, nor does it claim that Edwards & Hanly failed to mitigate its damages once the Richardson insolvency occurred. Let the clerk enter judgment for plaintiff for $1,441,122.45 plus interest from April 15, 1975.

So Ordered.

.....
U.S.D.J.

Dated: New York, New York
October 4, 1978.

Footnotes

1. Werba was able to make these advances because the WFSCC account at Morgan, to which WFB wired funds for the purpose of clearing trades generated "float" of about $10 million per day. This substantial balance arose because it took several days to clear checks issued in New York by WFSCC to pay delivered stock. (Werba, Tr. 28-29).

2. At trial, counsel for WFSCC objected to the admissibility of this statement on hearsay grounds. Counsel correctly argued that because Ianuzzi and Werba were no longer employed by WFSCC, her statement was not "a statement by [a party's] agent or servant concerning concerning a matter within the scope of [her] agency or employment, made during the course of the relationship." Rule 801(d)(2)(D), Fed. R. Evid., and thus not an admission by WFSCC. Nevertheless, the statement is admissible as an exception to the hearsay rule as a statement of Ianuzzi's then existing state of mind. Rule 803(3), Fed. R. Evid. A statement of the declarant's present state of mind is admissible to prove a past state of mind in issue. *See United States* v. *De Carlo*, 458 F.2d 358, 364-65 (3d Cir.), *cert. denied*, 409 U.S. 843 (1972); McCormick on Evidence § 295, at 696 (2d ed. 1972).

3. Gulemi, not unlike Werba, maintained close personal relationships with many Richardson employees. In 1974, he took three trips to California, including one during which he and the Richardsons planned a joint venture—the establishment of a restaurant business in Los Angeles. (Gulemi, Tr. 191-93).

4. It is highly doubtful, however, that this transaction occurred in November or December as Gulemi testified because Edwards and Hanly's records show no deliveries of stock on extraordinarily late trades during those months. (Defendant's Exhibit A).

5. The credit balance—a charge against the firm's capital—resulted from the accounting requirement that Edwards & Hanly carry the amount it owed Richardson for stock sold as an account payable even though the firm was technically not obligated to pay out any cash until Richardson made delivery. (Edwards, Tr. 161). Richardson's sales accounted for a large percentage of the firm's total credit balance after the transfer of the retail accounts on March 27th. (Foote, Tr. 343). It was not until the transfer of those accounts that the Richardson balance "stuck out like a sore thumb." (*Id.*)

6. Until February, 1975, one Mr. Reichart served as WFSCC's chairman. E. Alan Holroyde, a WFB Vice President, replaced

him. Holroyde and Ronald Hillman, a WFB vice president and WFSCC officer, supervised Werba. (Tr. 445).

7. Federal jurisdiction under § 10(b) turns on the "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." 15 U.S.C. § 78j. Richardson's use of the telephone suffices to confer federal jurisdiction. *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 93 n.19 (5th Cir. 1975).

8. Because the conduct engaged in by Richardson resulted in plaintiff buying in securities for Richardson's account and risk, but with loss of funds not presently recoverable from Richardson, the court concludes that plaintiff was a "purchaser" for the purposes of § 10(b). *See Weitzman* v. *Stein*, 436 F. Supp. 895, 901-2 & n.6 (S.D.N.Y. 1977).

9. In *Rolf*, the alleged aider and abettor was a registered representative employed by a registered broker-dealer. 570 F.2d at 41. The special obligations of broker-dealers to their customers to investigate and disclose have long been recognized. *Hanly* v. *SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969); *see Woodward* v. *Metro Bank of Dallas, supra*, 522 F.2d at 97 n.28. The *Rolf* court however did not premise its holding solely upon the nature of the registered representative's relationship to his customer. Rather, the court read *Hochfelder's* definition of scienter, "knowing or intentional misconduct," to permit the imposition of liability, for conduct less directed than "intentional" activity. 570 F.2d at 45. Moreover, the court found the recklessness construction to be "consistent with if not demanded by precedent in this circuit." *Id.* at 46. *Rolf* thus clearly implies that even in the absence of fiduciary obligations, the reckless defendant may incur § 10(b) liability.

10. The court nevertheless dismisses that portion of the complaint which seeks to recover for violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). The Court of Appeals for this circuit stated several years ago that the question whether § 17(a), a criminal provision, may be the source of an implied private right of action was an open question. *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1283 (2d Cir. 1969). Since that time, however, this district has repeatedly held that no such cause of action exists, *see, e.g., Scarfarotti* v. *Bache & Co.*, 438 F. Supp. 199, 207 (S.D.N.Y. 1977); *Architectural League of New York* v. *Bartos*, 404 F. Supp. 304 (S.D.N.Y. 1975), and this court adopts the reasoning set forth in those cases.

11. In some circumstances; of course, § 20(a) is a broader theory of secondary liability than common law agency notwithstanding the "good faith" defense. It is unnecessary under this section to establish the common law relationship of principal and agent or employer and employee. *Moscarelli* v. *Stamm*, 288 F. Supp. 453, 460 n.5 (E.D.N.Y. 1968).

12. Since *Hochfelder*, a number of circuits have reevaluated the "due diligence" defense to § 10(b) claims and have held that plaintiff's contributory fault must be tantamount to wanton, reckless conduct to bar recovery. In these circuits, plaintiff's mere negligence is no defense. *Sunstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 98 S. Ct. (1977); *Dupuy* v. *Dupuy*, 551 F.2d 1005, 1017-20 (5th Cir. 1977); *Holdsworth* v. *Strong*, 545 F.2d 687, 692-93 (10th Cir. 1976). In the Second Circuit, however, plaintiff's negligence may preclude, or at least limit, his recovery. *See Hirsch* v. *duPont, supra*, 553 F.2d at 763; *NBI Mortgage Investment Corp.* v. *Chemical Bank*, Fed. Sec. L. Rep. ¶ 96,066, at 91,799 (S.D.N.Y. 1977).

13. 15 U.S.C. § 78g(c)(1) states:

> (c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—
>
> (1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section.

14. Nor is WFSCC aided by § 29(b) of the Exchange Act, 15 U.S.C. § 78cc, which provides in pertinent part:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . the performance of which involves the violation of, or the continuance of any . . . practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the right of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract. . . .

This section merely "establishes that the guilty party is precluded from enforcing the contract against an unwilling innocent party, but it does not compel the conclusion that the contract is a nullity, creating no enforceable rights even in a party innocent of the violation. . . . [the section] render[s] the contract merely

voidable at the option of the innocent party . . . ." *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970). WFSCC is hardly an unwilling innocent party capable of invoking § 29(b). *See Naftalin* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra.* 469 F.2d at 1182. In any event, Edwards & Hanly is suing for fraud, not on its contract with Richardson.

15. WFSCC has raised various other affirmative defenses including alleged violations of § 10(a) of the Exchange Act, 15 U.S.C. § 78j(a); Rules 10a-1 and 10a-2, 17 C.F.R. §§ 240.10a-1 and 240.10a-2; New York Stock Exchange Rules 387, 431 and 433; and Article III, § 1 of the National Association of Securities Dealers Rules of Fair Practice. Assuming *arguendo* that violation of any of these provisions can preclude or limit recovery for fraud, the court finds that none of these defenses has merit.

Excerpts from Testimony.

FRANCIS J. MONIGAN, called as a witness by the defendant, having been first duly sworn, testified as follows:

Direct Examination by Mr. Masterson:

Q. Mr. Monigan, I want to place before you Defendant's Exhibits A, B, a copy of Exhibit C and Exhibit O, A, B and C being the account records, Exhibit O being the hypothetical fact situation.

You have seen all of these documents before? A. Yes, sir.

Q. Mr. Monigan, what is your business or occupation? A. I am an assistant vice-president, Dean Witter & Company.

Q. Would you briefly outline for the Court your business and educational experience after high school? A. I have a degree in electrical engineering from City College. My business experience basically. I started with Dean Witter & Company in 1955 as a clerk in the P & S department and I worked there through 1959, when I was made supervisor of the trade adjustment department, a position I retained until 1961, when I was inducted into the U.S. Army.

Returned to Dean Witter in 1963, and I was a supervisor in the order room from that date until 1968, when I was made the department head of broker fails and retained that title until 1971 when I received the additional duties of reconciliation of box differences; made assistant vice-president in 1972, as well as manager, certificate control, a position I retain to this date.

Q. So you have been with Witter for approximately 22 years? A. Yes, sir.

Q. Is it fair to say that during the course of your business with Witter you have been concerned mainly with the back office operations as opposed to the retail side? A. Solely, sir.

Q. To get right to it, Mr. Monigan, at my request have you examined the hypothetical fact situation, Exhibit O in evidence, and Exhibits A, B and C before you? A. Yes.

Q. Now, with respect to the matters stated therein, and assuming that all of the facts stated in the hypothetical are true and that Exhibits A, B and C are accurate portrayals of account activity in the account in question for the period stated, I want to ask you your opinion on the following subjects:

First, with respect to all of the sell orders described on the account exhibits placed with the broker or the member firm, could a prudent broker have had a good faith belief at the time all such sell orders were placed that the customer was long in securities which were the subjects of such orders? A. Yes, with a couple of exceptions.

Q. Now, with respect to the exceptions, are you able to identify those orders either with reference to a specific order or orders or as to a point in time; are you able to identify those orders as to which a prudent broker could not have had a good faith belief that the customer was long? A. Yes, sir. An order on a thousand shares of Halliburton which was sold December 13th and 1500 shares of Texas Instruments which was sold December 30th.

Q. All right, sir, I think it might be easier if you would come down here to the chart that we have on the board and indicate the orders that you have in question. A. This order here (indicating).

Q. When you say this order here, you are referring to a Halliburton order for a thousand shares on November 13th? A. Yes, sir.

Q. All right. And what is the other order? A. The other order is 1500 shares of Texas Instruments for a trade date of December 30th.

Q. Mr. Monigan, my question is whether a prudent broker could have had a good faith belief at the time the

order was placed, not whether that good faith opinion at some time dissipated and he had to think about buying in or not taking further orders.

Let me ask you the question again.

Mr. Gordon: Your Honor, I have heard the answer to this and I think he is going way beyond it.

The Court: All right.

Mr. Gordon: His witness has offered his opinion on this.

The Court: All right, yes, he has, but that's all right.

What is the next question?

Q. My question is I would like you to identify those orders as to which the broker could not have a good faith belief at the time the order was accepted that the customer was long? A. I will have to change my answer and say that up until the end of January all the orders placed he would have good faith.

Q. Mr. Monigan, I take it you didn't understand my question the first time I asked it? A. Yes.

Mr. Gordon: Objection. He is trying to resurrect his own witness, your Honor.

The Court: It's all right, Mr. Monigan, is what you are saying that as to all orders placed in the account prior to the end of January, 1975, all prior orders, yes, the broker could have a good faith belief that the customer was long at the time the order was placed?

A. At the time the order was placed, yes.

Q. All right, sir.

Now, could you tell the court the facts upon which you base that opinion which you have given. A. The fact is simply that although the deliveries were late, all transac-

tions were settled by the end of January, that delivery was actually made with two exceptions.

Q. What you are saying, sir, is—let me go on.

With respect to the orders to which you have testified, that the broker could have a good faith belief that the customer was long in the security, at the time the order was accepted, do you have an opinion as to whether there came a point in time when a broker could no longer continue to believe in good faith that the customer was long in securities in the orders that were already accepted? A. Yes, sir.

Q. When would that point in time be? A. Some time during the month of February.

Q. Would you state to the Court the facts upon which you base your opinion that as to the orders that were accepted in good faith that the broker could no longer continue to believe in good faith that the customer was long? A. The sale of a thousand shares of Halliburton which took place in November by the end of January still hadn't been delivered, which is over a 60-day time period, which is an unreasonable delay, and the 1500 shares of Texas Instruments was, by the end of January, almost 30 days past settlement date.

Q. Just a couple of more questions, Mr. Monigan.

In the hypothetical it indicates that the member firm in question bought in or did not buy in the account until April 15, 1975.

My next question to you is this:

Would a prudent broker under the circumstances of this account be justified in waiting until April 15, 1975 to commence buy in procedures? A. No, sir.

Q. Do you have an opinion on the subject as to that point in time prior to April 15, 1975 when a prudent broker should have commenced buy in procedures? A. Yes, sir.

Q. What is that point in time? A. Some time in the early part of March 1975. To be exact, March 7 when another trade of 1500 shares of Halliburton failed, one day past settlement date.

Q. You are referring to the top line on Exhibit A-1 immediately underneath the old Halliburton trade of 1000 shares, is that correct? A. Yes, sir.

Q. Would you please tell the Court the facts upon which you based your opinion that that point in time would have been the point in time when you would have done something? A. First, that there is no way that an answer couldn't have been gotten and delivery had been received on the two positions which were failing, which were being failed on by the end of February.

In my experience there has never been a reason for delay that long without actually being taken, and, second, by that point in time the broker was also at risk. Prior to that date there was no risk but by March 7 the broker was a risk over $30,000 and it appeared that there was very little trading going on in the account at that point in time. And at this point in time with that type of risk I would have stopped trading for the account until the deliveries were made.

Q. Is that the first thing which would have been done, stop trading? A. The first thing that would have been, yes.

Q. Why is that, sir? A. Because at the time the one trade on 1500 Texas Instruments, if it wasn't delivered the firm was out of pocket $42,000 if they had to buy in, buy in that trade and with that type of exposure there was no point to let it increase by accepting further orders.

Q. In addition to ceasing trading or stopping taking orders in the account, what other steps should a prudent broker have done under the circumstances being the first day after this fail of this 1500 shares of Halliburton with a trade date of March 26? What other steps should the

broker have done? A. The broker should have advised the customer that he was being bought in unless he made delivery.

Q. I meant to say February 26 instead of March 26.

Please start your answer again. A. On February 26?

Q. I will start all over again. I am sorry, I have confused the record.

My question is what other steps should a prudent broker have undertaken on March 7, the first day of a fail of this Halliburton trade of 1500 shares which had a trade date of February 26? A. As I said, the broker should have stopped taking orders for the client and advised him that if he did not make delivery within 24 hours the other two fails would be bought in.

Q. In connection with giving your opinion, have you relied in any respect upon the net risk figure set forth in the Defendant's Exhibit B? A. Yes, I have very much so, because of the fact that the account had a history of delays in delivery so that apparently the delays were tolerated that as such the only real basis of taking affirmative action at this point would be the exposure to the broker.

Q. Earlier in the account there were certain times when the account was at risk. This would be back in December and possibly early in January.

It is your testimony, however, that at no point in time you would not have taken steps with respect to the account back in December or early January? A. No, sir, not based upon the history of the account with their delay in delivery.

Q. Is what you are saying is that you might have tried to have this string of trades run out but then on the very next fail date of the following series of trades you would have bought in?

Mr. Gordon: Objection.

The Court: You are repeating what he said.

Mr. Masterson: I am sorry.

Q. Assuming that the prudent broker called the customer on March 7, March 8 and inquired about the stock and assuming that the customer gave some delay that the stock was either out for transfer or the customer hadn't received it in from the other side of the trade, how long if any should a prudent broker have delayed before commencing buy in procedures? A. According to the question that the broker had already been in touch with the customer in January regarding that trade and he should have received some type of an answer. So that any type of answer on March 7 other than the physical certificate numbers which would be delivered the next day wouldn't be a satisfactory answer.

Q. And at that point buy in would have to take place? A. Yes, sir.

Mr. Masterson: Cross-examine.

Cross Examination by Mr. Gordon:

Q. Me. Mr. Monigan, if I understand your testimony correctly, up until February you recognized that this account was chronically late in delivering and you state, I believe, that that is a situation which you would have tolerated, is that correct? A. Not that I would personally tolerate it but by the situation of the question it says it was tolerated.

Q. And I believe you said in your testimony that a fail period of 60 days is not that unusual a fail period in dealing with DVP/RVP accounts? A. No, I did not say that.

Q. Is it nonetheless a period which you, according to the stipulation in the question, that we don't have anywhere

near that much here but a period here of let's say, 20 days or so during this period of time, what about 20 days, is that a period which is something which is tolerated normally in the business? A. In my opinion, yes, sir.

Q. How far would you extend that? How long a period is normally tolerated in the business on failings? A. No more than 26 days.

Q. 26 days? A. Yes.

Q. Do you tie that into the mandatory 30-day buy and hold on exchange contracts? A. Yes, sir.

Q. But, of course, here we don't have—I presume you know we don't have contracts between exchange of members as such, you know that? A. Yes, sir.

Q. But you are saying that you tie the period of approximately 26 days in because that is the period that is provided in the exchange contract regulation basically, correct? A. Yes, sir.

Q. Just forget for a moment, and I will get back to the Halliburton and the Texas Instruments for a moment, that is 26 days past settlement date, right? A. Yes, sir.

Q. Let's go over into these March trades for a moment.

If you want to look at them, if you have looked at them before, there are very few if any trades that went 26 days past settlement days. Let's forget Halliburton and Texas Instruments. Other than those two stocks you have few trades that went 26 days past settlement date, right? A. As I said, I would have closed the account out on March 7.

Q. You would have done it because of the Halliburton and Texas Instruments? A. And my exposure, sir.

Q. Leave that aside for a second and I will get back to that with you. Just eliminate that for a moment.

You do concede that on the March trades anyway you have very few if any that went really more than much past 26 days past settlement date, right? A. 26 days, of course, is an outside limit.

Q. I understand that is your testimony that you consider that as an outside limit? A. There is also the second point of exposure.

Q. We will get to that also in a moment. All I am trying to do now is get your acknowledgment that at least with respect to March trades, forgetting all the rest of it and the history of the accounts, that with respect to the March trades as such trading them as a block there is really nothing here that goes 26 days beyond settlement date, correct? A. No. No, I see trades that settled in the early part of March that were never delivered.

Q. You have the 10th of March going on to the 15th of April, something like that, right? A. Yes, sir.

Q. Well— A. Some earlier than that.

Q. Within a day or so. They settled—let's say starting March 8—well, I don't know. March 10 really was the earliest one which ultimately failed, right? A. Yes, sir.

Q. So you have March 10 until April 15. It's 30 days is what you say is the contract, the Stock Exchange limit. The 26 days is sort of a guideline as to when you in the street on these exchange contracts start getting around to really putting pressure on with the anticipation of buying in on the 30-day, right? A. The 26 days would be the time you put the pressure on to execute the buy in on the 30th day.

Q. But according to what you say the buy in period is 30 days. Are these calendar days or business days? A. Calendar days, sir.

Q. March 10 to April 10, let's say, the earliest trade that failed is March 10, you have April 10. You are talking about an additional five days. I will get to that with you in a second.

In fact, why don't we get to that one right now.

Let's suppose hypothetically that on or about the 26th day of these March trades, give or take a few days, and

remembering this is not an exchange contract, you call up the clearing corporation and the clearing corporation says "Yes, we know the trade, we have instructions that the stock is coming."

Would that be a basis on which you might extend it for another couple of days? A. No, sir.

Q. Under no circumstances? A. Not with the exposure that was in the account at that point in time.

Q. Let's forget the exposure for a minute. I understand what you are saying. What you are saying is that you probably wouldn't do it because the firm was at risk and you wouldn't want to hurt the firm, right? A. Yes, sir.

Q. But let's put that aside for the moment as sort of a business risk. Just take it on the basis of notwithstanding the fact you didn't want to hurt the firm, you called the clearing corporation and they say we know the trades, we got instructions and the stock is coming.

Now, assuming for the minute that the firm for one reason or another is willing to take the business risk of extending that credit, of extending that position for that extra few days, isn't it a fact that you could and probably would on that basis rely on the clearing corporation's acknowledgment that they knew the trade and had the instructions and at that point at least put some reliance on that in terms of not buying the account in? A. The answer to the question is no, sir, because of the concentration of the sales that were taking place and what I would assume would be the broker's need for the stock to satisfy his obligations.

Mr. Masterson: He didn't finish the answer.

Q. Let's take that out for a second.

The broker managed by going to the box or borrowing on the street, while the broker had a need for the stock

and there was some pressure on the street side, let's eliminate that for a moment as an absolutely key and critical point too.

What I am trying to get to is if you call up a clearing corporation and they say they know the trades and they have instructions that is a factor which a broker would be entitled to take into account in determining whether to buy an account in, isn't that it?

Mr. Masterson: I have to object. Counsel has taken so many things—

The Court: All that does is decrease the value of the question but I think it's permissible.

(Question read.)

A. It is a factor but I would need more information before I would accept that as an excuse not to buy in the account.

Q. Fair enough. Let me then ask you, is part of the information you would need that this account had a four or five-year history and as you have testified there had been late deliveries before and that that had been tolerated before, would that be one of the factors that you would want to know about? A. Yes, sir.

Q. Would another one of the factors that you might want to know about the fact that during this last, let's say, from the 26th day through to the end, that there had been deliveries of stock made during that period of time, partial deliveries on some of the open positions, would that be a factor that you would want to know? A. Yes, sir.

Q. From the look on your face, if I can interpret it, would that be a very important factor that you might be interested in knowing, the fact that there had been, in fact, partial deliveries during this period of time? A. No, sir.

Q. It would nonetheless be a factor? A. Yes, sir.

Q. Would another factor be that you called up the customer and the customer said to you in words or in substance "We are delivering part of it today and the rest of it will be coming by the end of the week", and part of it came in that day, would that be a factor that you would want to consider? A. Yes, sir.

Q. Let me go back for a moment to these two trades which you say give you the most trouble. That is the Halliburton trade and the Texas Instruments trade.

Let's take Texas Instruments first because I think here you have an old item for 1500 shares going all the way back to the December 30th trade date, January 7th settlement date, and you say call up until 26, 30 days after the settlement date brings it to March 7, March 8.

That 1500 shares isn't in. Assume you have had this account for four, five years and that is the only item open. Sure, it's on old item but you have had this account for four or five years. Other than that, perhaps 1000 shares, or something else, the account is flat. There had been no orders placed in the account in February at all. February is a complete blank and deliveries prior to that time had been made.

Assume all of that for a second. Isn't it conceivable that a broker under those circumstances would say that with respect to assuming the risk in just that 1500 shares of one stock and 1000 of the other that because of the history of the account that he might be willing to continue to accept orders? A. Yes, I guess so.

Q. You were talking before, and I don't want to go too much further with this, you were talking before about the risk position to the firm and you said that certainly there came a point in March where the risk position to the firm was such that you anyway would have bought the account

in to avoid further risk to the firm, is that basically your testimony? A. Yes, sir.

Q. Are you aware that in 1975 there was a New York Stock Exchange rule concerning the aging of fails and the way in which that was applied to a capital account, a net capital account? A. No, sir.

Q. Let me again go back for a second and let me give you the following additional facts and all I would like to ask you is whether these might be factors in your determining that perhaps that was a tolerable risk to take.

Factor No. 1 is that this account is five years old, that it's been through three brokerage firms, all member firms, all substantial member firms, one firm acquired an office, that it has always delivered before although the deliveries have been late, that it was a very good account producing a substantial amount of business, that from time to time within the past week or two prior to the time this risk position was assumed calls had been made to the clearing corporation which had said that they had certain stock and it would be coming in and, in fact, came in, other calls were made to the clearing corporation and they said they knew the trades or had instructions, aren't all of these factors which a broker might well consider in determining to allow the risk to continue for some period of time so as in order not to lose this account at this point?

Mr. Masterson: Could I inquire as to what point in time is counsel now questioning on?

Mr. Gordon: I thought I was in the middle of whenever he said, the middle of March.

Mr. Masterson: There is no evidence to indicate that any contact was made with the clearing corporation prior to March 15.

Mr. Gordon: Not at all. There was a contract in January, I believe.

Mr. Masterson: Counsel's question was that

these calls had been going on to the clearing corporation in which they said they knew the trade. The only evidence prior is in January when a call was made about one stock.

The Court: All right. Take that modification.

Q. Did you follow what I said? A. No. You have to repeat the question.

Q. In the middle of March you find that you have a risk to the brokerage firm of about $200,000, something like that, a little less perhaps. Let's just agree on a figure. A. The risk was 194,000.

Q. I will take that. 194,000 in March. This has been a big account for five years to produce a substantial amount of business, a substantial amount of commissions. It's always delivered before although the deliveries have been past settlement date, with the exception of a couple of old trades which we have discussed before all of the trades at that point are relatively new, all within the past week or so in terms of settlement date. Isn't it conceivable under those circumstances that a broker might well determine that in order not to lose this account or not to lose the business and in view of the past good faith history of the account to allow this use to continue for a little longer? A. No, sir.

Q. It is not reasonable in any respect for that to have happened? A. Not in my opinion, sir, not with the lack of deliveries being made in that time period.

Q. Wait a minute now. In terms of lack of deliveries, the only things that were open for any length of time, more than a couple of days past settlement date by that point, was this one 1500 Texas Instruments and a thousand Halliburton, is that correct? A. No, sir, not on March 17th.

Q. You have testified already that a 30-day period is an allowable period.

Mr. Masterson: I object to that. That is not

what he testified to.

The Court: Yes.

Mr. Gordon: Well, all right.

The Court: It is in an individual case, but not when you have got a series of them.

Isn't that what you said?

The Witness: That's correct, yes, sir.

Q. As of that date, let's say March 17th, other than these two trades, you didn't have a series of aged fails at that point, did you? A. I had a series of fails, sir.

Q. Yes, but— A. Aged or otherwise, the exposure in the value in the account, the short market value, if you will of it—because there were sales—had increased, at that point in time was almost $4 million, which is substantially higher than the 250,000, if I'm not mistaken, at the end of February, with the trade of the Halliburton and the Texas Instruments.

Q. Right. But how was that risk compared with the risk back here, do you know? A. I'd have to look back there. You will have to give me a date, sir.

Q. Well, let me see—

The Court: End of January.

The Witness: At the end of January there was no risk to the brokerage firm and the value of the positions was only $400,000.

Q. All right. That is the point where I think you said before, because of the aged fails in the two stocks, you think you would have bought the account in somewhere around there, February, something like that, right? A. No, I would say closer to the end of February because that's when the risk was going against me.

Q. This risk situation that you are describing, this is a situation in which a brokerage firm is required to take a charge against capital, is that correct? A. Yes, sir.

Monigan—cross.

Q. And most brokerage firms, am I correct, are up to a point prepared to take that charge against capital for certain types of accounts provided that they have some reasonable assurances of delivery, isn't that right? A. Yes, sir.

Q. I mean brokerage firms do this all the time, don't they? A. Yes, sir.

Q. And it is nonetheless your testimony that in this particular case, this brokerage firm, which had had this account for five years, and had had this history, was not entitled to take this risk, is that your opinion? A. That is my opinion, sir.

Mr. Gordon: No further questions.

Mr. Masterson: I have no questions, your Honor.

The Court: You may step down.

(Witness excused.)

Mr. Masterson: Defendant rests, your Honor.

Statutory Appendix

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78(g)

MARGIN REQUIREMENTS

SEC. 7. (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of—

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of under-margined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this

subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section:

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit

initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security in contravention of such rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to a loan by bank on a security other than an equity security, or (E) to such other loans as the Board of Governors of the Federal Reserve System shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

(e) The provisions of this section or the rules and regulations thereunder shall not apply on or before July 1, 1937, to any loan or extension of credit made prior to the enactment of this title or to the maintenance, renewal, or extension of any such loan or credit, except to the extent that the Board of Governors of the Federal Reserve System may by rules and regulations prescribe as necessary to prevent the circumvention of the provisions of this section or the rules and regulations thereunder by means of withdrawals of funds or securities, substitutions of securities, or additional purchases or by any other device.

(f)(1) It is unlawful for any United States person, or any foreign person controlled by a United States person or acting on behalf of or in conjunction with such person, to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender (without regard to whether the lender's office or place of business is in a State or the transaction occurred in whole or in part within a State) for purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited or would be prohibited if it had been made or the transaction had otherwise occurred in a lender's office or other place of business in a State.

(2) For the purposes of this subsection—

(A) The term "United States person" includes a person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust.

(B) The term "United States security" means a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State.

(C) The term "foreign person controlled by a United States person" includes any noncorporate entity in which United States persons directly or indirectly have more than a 50 per centum beneficial interest, and any corporation in which one or more United States persons, directly or indirectly, own stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock.

(3) The Board of Governors of the Federal Reserve System may, in its discretion and with due regard for the purposes of this section, by rule or regulation exempt any class of United States persons or foreign persons controlled by a United States person from the application of this subsection.

REGULATION X

12 CFR § 224.2(a)

Section 224.2—General Rule

(a) *Credit obtained from within the United States.* A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:

(1) Credit obtained from a G-lender shall conform to the provisions of Part 207 (Regulation G), which is hereby incorporated in this part (Regulation X). When the term "G-lender" is used in this part (Regulation X), it means a person who is not a broker/dealer or bank, who in the

ordinary course of his business extends, maintains, or arranges credit that is secured, directly or indirectly, in whole or in part, by collateral that includes any margin securities, and who is subject to the registration requirement of section 207.1(a) of Part 207 (Regulation G).

(2) Credit obtained from a broker/dealer shall conform to the provisions of Part 220 (Regulation T), which is hereby incorporated in this part (Regulation X). When the term "broker/dealer" is used in this part (Regulation X), it means a person who is a broker or dealer, including every member of a national securities exchange, and includes a foreign branch or subsidiary of a broker/dealer.

(3) Credit obtained from a bank shall conform to the provisions of Part 221 (Regulation U), except for section 221.2(i). Except for such section, Part 221 (Regulation U) is hereby incorporated in this part (Regulation X). When the term "bank" is used in this part (Regulation X), it means a bank that is subject to Part 221 (Regulation U).

SECTION 224.6—MISCELLANEOUS PROVISIONS

(a) *Innocent mistake.* An innocent mistake made in good faith by a borrower in connection with the obtaining of a credit shall not be deemed to be a violation of this part (Regulation X) if promptly after discovery of the mistake the borrower takes whatever action is practicable to remedy the non-compliance.

(b) *Aiding or abetting.* Any person who wilfully aids or abets the violation by any other person of any provision of this part (Regulation X) shall be deemed to be in violation of this part (Regulation X). For the purpose of this paragraph, the term "aids or abets" shall include, but not be limited to, counsels, commands, induces, or procures.

Rule 10a-1(d) under the Securities Exchange Act of 1934,

17 C.F.R. § 240.10a-1(d)

* * *

(d) No broker or dealer shall mark any order to sell a security registered on, or admitted to unlisted trading privileges on, a national securities exchange "long" unless (1) the security to be delivered after sale is carried in the account for which the sale is to be effected, or (2) such broker or dealer is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected.

* * *

Rule 10a-2(a) under the Securities Exchange Act of 1934,

17 C.F.R. § 240.10a(2)

(a) No broker or dealer shall lend, or arrange for the loan of any security registered on, or admitted to unlisted trading privileges on a national securities exchange for delivery to the broker for the purchaser after sale, or shall fail to deliver a security on the date delivery is due, if such broker or dealer knows or has reasonable grounds to believe that the sale was effected, or will be effected, pursuant to an order marked "long", unless such broker or dealer knows, or has been informed by the seller, (1) that the security sold has been forwarded to the account for which the sale was effected, or (2) that the seller owns the security sold, that it is then impracticable to deliver to such account the security owned and that he will deliver such security to such account as soon as it is possible with out undue inconvenience or expense.

Rule 10b-5 under the Securities Exchange Act of 1934,

17 C.F.R. § 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

REGULATION T

12 CFR § 220.4(a), (c)

SECTION 220.4—SPECIAL ACCOUNTS

(a) *General rule.* (1) Pursuant to this section, a creditor may establish for any customer one or more special accounts.

(2) Each such special account shall be recorded separately and shall be confined to the transactions and relations specifically authorized for such account by the appropriate paragraph of this section and to transactions and relations incidental to those specifically authorized. An adequate record shall be maintained showing for each such account the full details of all transactions in the account.

(3) A special account established pursuant to this section shall not be used in any way for the purpose of evading or circumventing any of the provisions of this part. If a customer has with a creditor both a general account and one or more such special accounts, the creditor shall treat each such special account as if the customer had with the creditor no general account, special bond account subject to § 220.4(i), or special convertible security account subject to § 220.4(j).

(4) The only other condition to which transactions in such special accounts shall be subject under the provisions of this part shall be such conditions as are specified in the appropriate paragraph of this section and in §§ 220.2, 220.6, 220.7, or 220.8, except insofar as § 220.3 applies to §§ 220.4(i), and (j).

* * *

(c) *Special cash account.* (1) In a special cash account, a creditor may effect for or with any customer *bona fide* cash transactions in securities in which the creditor may:

(i) Purchase any security for, or sell any security to, any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment.

(ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

(3) If the security when so purchased is an unissued security, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is made available by the issuer for delivery to purchasers. If the security when so purchased is a "when distributed" security which is to be distributed in accordance with a published plan, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is so distributed. If the security when so purchased is a new security issued or to be issued for the purpose of refunding outstanding securities which mature, or are to be payable upon presentation for redemption, within 35 days of the date on which the new security is made available by the issuer for delivery to purchasers, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after such maturity or payment date: *Provided,* That this sentence shall apply only to the payment of that portion of the purchase price that does not exceed 103 per cent of the amount that will be payable to the purchaser of the new security upon such maturity of, or payment for, securities owned by him at the time of the purchase.

(4) If any shipment of securities is incidental to the consummation of the transaction, the period applicable to the transaction under subparagraph (2) of this paragraph shall be deemed to be extended by the number of days required for all such shipments, but not by more than 7 days.

(5) If the creditor, acting in good faith in accordance with subparagraph (1) of this paragraph, purchases a security for a customer, or sells a security to a customer, with the understanding that he is to deliver the security promptly to the customer, and the full cash payment to be made promptly by the customer is to be made against such delivery, the creditor may at his option treat the transaction as one to which the period applicable under subparagraph (2) of this paragraph is not the 7 days therein specified but 35 days after the date of such purchase or sale.

(6) If an appropriate committee of a national securities exchange or a national securities association is satisfied that the creditor is acting in good faith in making the application, that the application relates to a *bona fide* cash transaction, and that exceptional circumstances warrant such action, such committee, on application of the creditor, (i) may extend any period specified in subparagraphs (2), (3), (4), or (5) of this paragraph for one or more limited periods commensurate with the circumstances, or (ii), in case a security purchased by the customer in the special cash account is a margin or exempted security, may authorize the transfer of the transaction to a general account, special bond account, special convertible security account, or special omnibus account, and the completion of such transaction pursuant to the provisions of this part relating to such an account.

(7) The 7-day periods specified in this paragraph refer to 7 full business days. The 35-day period and the 90-day period specified in this paragraph refer to calendar days, but if the last day of any such period is a Saturday,

Sunday, or holiday, such period shall be considered to end on the next full business day. For the purposes of this paragraph, a creditor may, at his option, disregard any sum due by the customer not exceeding $100.

(8) Unless funds sufficient for the purpose are already in the account, no security other than an exempted security shall be purchased for, or sold to, any customer in a special cash account with the creditor if any security other than an exempted security has been purchased by such customer in such an account, and then, for any reason whatever, without having been previously paid for in full by the customer, the security has been sold in the account or delivered out to any broker or dealer during the preceding 90 days: *Provided,* that an appropriate committee of a national securities exchange or a national securities association, on application of the creditor, may authorize the creditor to disregard for the purposes of this subparagraph any given instance of the type therein described if the committee is satisfied that both creditor and customer are acting in good faith and that circumstances warrant such authorization. For the purposes of this subparagraph, the cancellation of a transaction, otherwise than to correct an error, shall be deemed to constitute a sale. The creditor may disregard for the purposes of this subparagraph a sale without prior payment provided full cash payment is received within the period described by subparagraph (2) of this paragraph and the customer has not withdrawn the proceeds of sale on or before the day on which such payment (and also final payment of any check received in that connection) is received. The creditor may so disregard a delivery of a security to another broker or dealer provided such delivery was for deposit into a special cash account which the latter broker or dealer maintains for the same customer and in which account there are already

sufficient funds to pay for the security so purchased; and for the purpose of determining in that connection the status of a customer's account at another broker or dealer, a creditor may rely upon a written statement which he accepts in good faith from such other broker or dealer.

FEDERAL RULES OF CIVIL PROCEDURE

RULE 52. FINDINGS BY THE COURT

(a) *Effect.* In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).

Schedule of Stocks Delivered
March and April 1975

Security	*Trade Date*	*Settlement Date*	*Number of Shares*	*Delivery Date*
Halliburton	March 4, 1975	March 10, 1975	3,000	March 14, 1975
Halliburton	March 3, 1975	March 7, 1975	2,000	March 14, 1975
Halliburton	February 27, 1975	March 6, 1975	1,000	March 25, 1975
Halliburton	November 13, 1974	November 20, 1974	1,000	March 25, 1975
Burroughs	March 26, 1975	April 3, 1975	2,500	April 7, 1975
Burroughs	March 24, 1975	April 1, 1975	3,000	April 7, 1975
Burroughs	March 4, 1975	March 11, 1975	3,000	April 7, 1975
Xerox	March 14, 1975	March 25, 1975	4,000	April 3, 1975

EXHIBIT A-1

SUMMARY OF 58 EDWARDS & HANLY SALES ORDERS EXECUTED ON BEHALF OF RICHARDSON BETWEEN NOVEMBER 1, 1974 AND APRIL 15, 1975 IN SIX STOCKS: TEXAS INSTRUMENTS, HALLIBURTON, DIGITAL EQUIPMENT, FAIRCHILD CAMERA, DUPONT, AND SCHLUMBERGER

(BUSINESS DAYS ONLY INCLUDED)
(TWO PURCHASE ORDERS NOT INCLUDED)

KEY:
S= SALE
DUE = DELIVERY DATE AFTER WHICH STOCK IS IN A FAIL POSITION
D= DELIVERY AGAINST PAYMENT

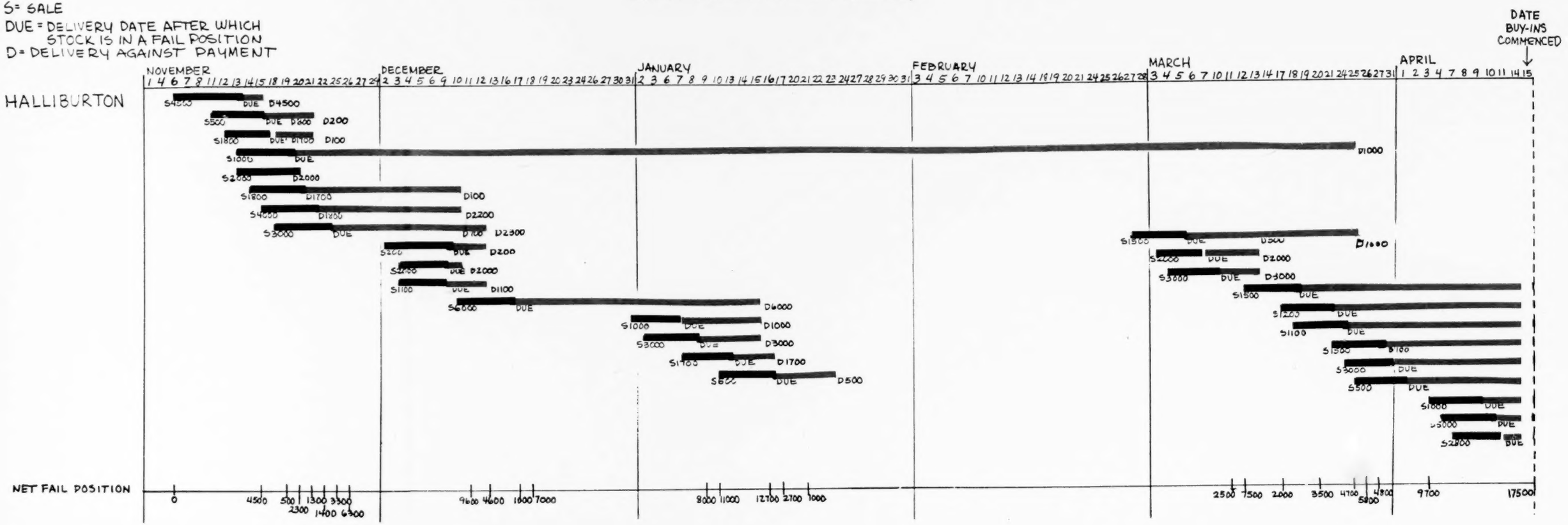


EXHIBIT A-2

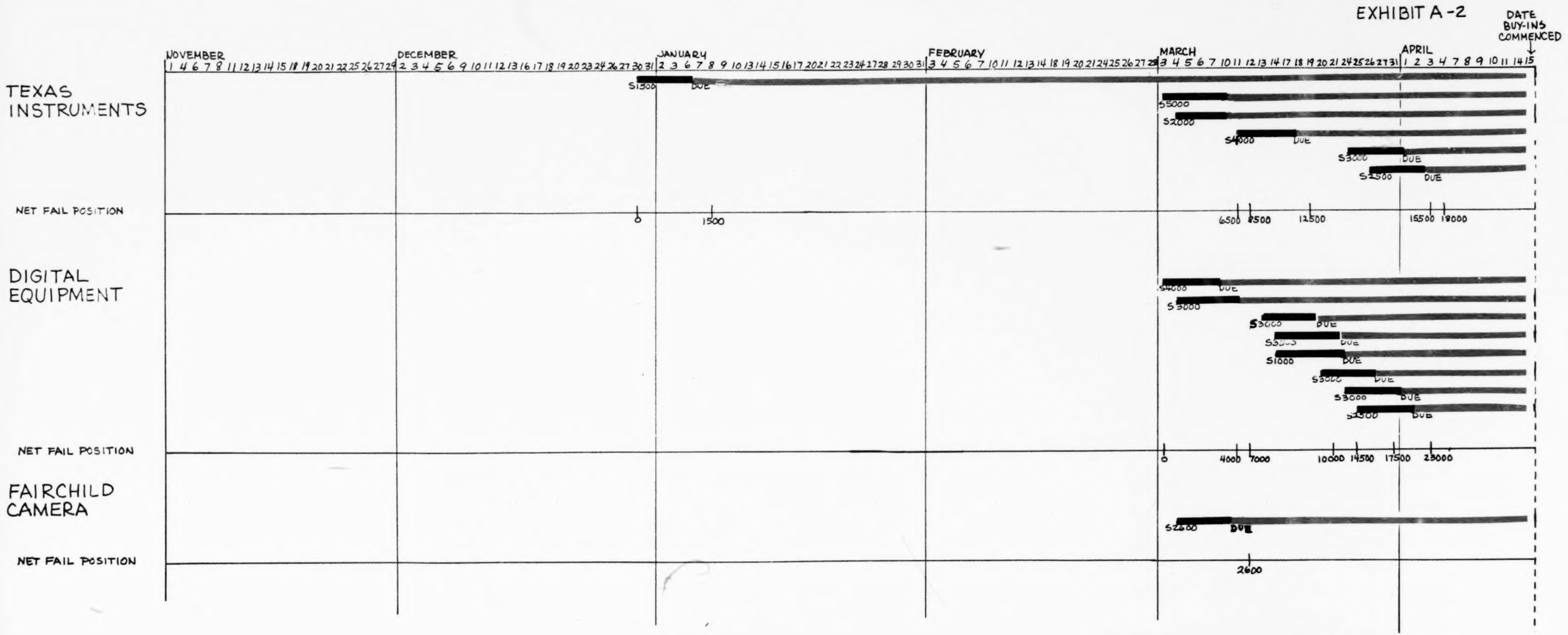
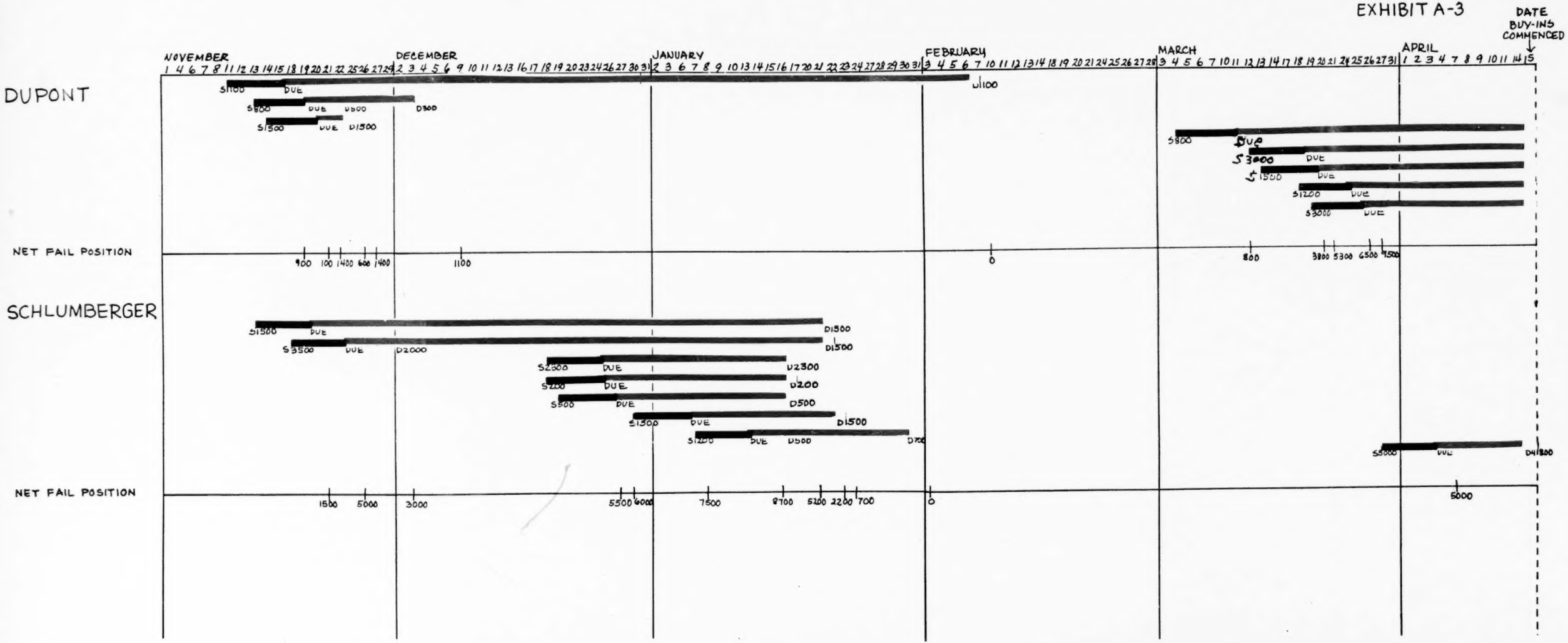

DATE BUY-INS COMMENCED
NOVEMBER
DECEMBER
JANUARY
FEBRUARY
MARCH
APRIL
TEXAS INSTRUMENTS
$1500 DUE
$5000
$2000
$4000 DUE
$3000 DUE
$2500 DUE
NET FAIL POSITION
0
1500
6500 8500 12500 15500 18000
DIGITAL EQUIPMENT
$4000 DUE
$3000
$3000 DUE
$1000 DUE
$3000 DUE
$3000 DUE
$2500 DUE
NET FAIL POSITION
0
4000 7000 10000 14500 17500 23000
FAIRCHILD CAMERA
$2600 DUE
NET FAIL POSITION
2600

EXHIBIT A-3


DATE BUY-INS COMMENCED
NOVEMBER
DECEMBER
JANUARY
FEBRUARY
MARCH
APRIL
DUPONT
$100 DUE
$800 DUE D800
D300
$1500 DUE D1500
D1100
$800 DUE
$3000 DUE
$1500 DUE
$1200 DUE
$3000 DUE
NET FAIL POSITION
900 100 1400 600 1400
1100
0
800
3800 5300 6500 1500
SCHLUMBERGER
$1500 DUE
D1500
$3500 DUE D2000
D1500
$2300 DUE
D2300
$200 DUE
D200
$500 DUE
D500
$1500 DUE
D1500
$1200 DUE D500
D700
$5000 DUE
D41800
NET FAIL POSITION
1500 5000 3000
5500 6000 7500 8700 5200 2200 700
0
5000

Supreme Court, U. S.
FILED
DEC 28 1979
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-828

EDWARDS & HANLY,
Petitioner,

v.

WELLS FARGO SECURITIES CLEARANCE CORPORATION,
Respondent.

On Petition For a Writ of Certiorari To The United States Court of Appeals For The Second Circuit

---

RESPONDENT'S BRIEF IN OPPOSITION

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IN THE

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---

RESPONDENT'S BRIEF IN OPPOSITION

Respondent Wells Fargo Securities Clearance Corporation (herein "WFSCC") respectfully requests that this Court deny Edwards & Hanly's petition for writ of certiorari seeking review of certain parts of the Second Circuit's opinion in this case, reported at 602 F.2d 478.

QUESTIONS PRESENTED FOR REVIEW

Petitioner Edwards & Hanly (herein "E&H") presents questions for review (Petition ("P."), pp. 2-3) which are either not in this case or not critical to its resolution.

Question One (P., p. 2) is whether certain duties of broker/dealers under Regulation T are defined solely by "objective" standards or by "subjective" standards, with E&H claiming that the Court of Appeals erroneously used solely "objective" standards. However, the Second Circuit did not apply solely "objective" standards; it applied a "subjective" test in line with rulings of other courts (Petition Appendix ("P.A."), pp. 17a-25a, 27a).

Question Two (P., p. 2) is whether a broker/dealer's violation of Regulation T *or* its negligence in failing to buy in securities for the account of a defaulting customer is a complete bar to such broker/dealer's recovery of damages. However, the Second Circuit did not so conclude. Instead, it held that since E&H's monetary loss was caused by its own actions, careless indifference and lack of due diligence, E&H could not recover its monetary loss from WFSCC (P.A., pp. 16a-25a, 27a). In so holding the Second Circuit found that E&H's lack of due diligence was established by numerous factors, including E&H's conscious violations of Regulation T *and* E&H's "careless indifference to the ordinary and accessible means of information" (P.A., pp. 16a-25a, 27a). At no point in its opinion did the Second Circuit indicate that a broker/dealer's Regulation T violation *or* negligence, either standing alone, is a complete bar to the recovery of damages by such broker/dealer.

Question Three (P., p. 3) assumes that the Second Circuit engaged in improper appellate procedure and found facts not supported by the record in this case. The Court

of Appeals applied the law to the facts in the record and clearly has *not* "so far departed from the accepted and usual course of judicial proceedings . . . as to call for an exercise of this court's power of supervision." United States Supreme Court Rule 19(b).

STATEMENT OF THE CASE

WFSCC relies on the statement of facts in the opinion of the Court of Appeals (P.A., pp. 3a-12a). E&H's statement of the case is inaccurate in certain important respects:

(1) The District Court did not find that WFSCC was an aider and abettor of Richardson as claimed by E&H (P., p. 5). Rather, the District Court found that WFSCC's employee Werba was an aider and abettor of Richardson and that WFSCC was vicariously liable to E&H either on the theory that WFSCC was Werba's principal or on the theory that WFSCC was a control person and had failed to adequately supervise Werba (P.A., pp. 56a-58a). In addition to disagreeing with the District Court's conclusion that WFSCC could be liable to E&H by reason of inadequate supervision of Werba (P.A., pp. 15a-16a), the Court of Appeals found that Werba's aiding and abetting liability had not been established since (i) Werba did not substantially assist Richardson in its fraud (P.A., p. 12a) and (ii) it was not clear that Werba had the required degree of scienter (P.A., p. 14a-15a). The Court of Appeals rejected the "but for" theory of causation applied by the District Court (P.A., p. 13a) and agreed with the District Court that Richardson's fraud "was not the short selling but the failure by Richardson to tell E&H that it was selling short" (P.A., pp. 12a, 51a). The Court of Appeals also refused to decide whether vicarious liability could arise based on agency principals (P.A., pp. 15a-16a). E&H has not challenged any of these rulings in this Court.

(2) There is no evidence in the record to support E&H's assertion that Werba knew the type of accounts Richardson maintained with broker/dealers, including E&H (P., p. 5). The District Court found that Werba knew that Richardson's accounts were cash delivery vs. payment accounts and should have known that short sales could not be made in such accounts (P.A., p. 53a). As pointed out to the Court of Appeals, there is no evidence in the record to support this finding.

(3) The Court of Appeals did not hold that "the tolerance as an industry standard of 3 week delays in delivery from third market brokers constituted a violation of Regulation T" (P., p. 8). The Court of Appeals did not acknowledge the existence of such an industry standard. The District Court acknowledged that brokers' delays of over three weeks were tolerated and that brokers were allowed more time to effect deliveries than was accorded retail customers (P.A., p. 67a). To the extent this finding was based on Mr. Monihan's testimony, it is clear that Monihan was talking about fails in the context of exchange contracts between member firms acting as brokers (P.A., pp. 79a-80a). As the Court of Appeals correctly noted, Richardson was a customer of E&H with respect to all transactions at issue in this case and the Richardson account is held to the same standard as any retail customer under Regulation T (P.A., p. 18a).

(4) The Court of Appeals did not reject a "totality of circumstances" test in determining whether there was a violation of Regulation T (P., p. 8). After reviewing the totality of the circumstances, the Court of Appeals concluded as a matter of law that E&H failed to exercise due diligence, citing as one primary cause E&H's failure to comply with Regulation T.

REASONS WHY THE WRIT SHOULD BE DENIED

There is no reason for this Court to review the Second Circuit's opinion in this case. The decision of the Court of Appeals is not in conflict with decisions of other courts of appeals or with any decisions of this Court. There is no important question for this Court to review. Nor is there any occasion for this Court to exercise its supervisory authority over lower federal courts. The Second Circuit's decision is based upon the complex, unusual and unique facts of this case.

I

THE SECOND CIRCUIT'S ANALYSIS OF A BROKER/DEALER'S DUTIES UNDER REGULATION T IS IN ACCORD WITH ANALYSES OF OTHER COURTS. NO IMPORTANT QUESTION OF FEDERAL LAW IS PRESENTED BY THIS CASE.

In analyzing the duties of E&H (a broker/dealer) under Regulation T concerning sales in a cash account, the Second Circuit followed the principles set forth in the leading case of *Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972). These same principals have been followed in other reported cases involving analogous factual situations. *See, e.g., Grimes, Hooper & Messer, Inc. v. Pierce,* CCH Fed. Sec. L. Rptr. ¶ 95,341 (C.D. Ca. 1973), *aff'd per curiam,* 519 F.2d 1089 (9th Cir. 1975); *Thomson McKinnon Securities, Inc. v. Hornung,* 69 App. Div. 2d 118, 419 N.Y.S.2d 526 (1979).

E&H does not quarrel with the *Naftalin* decision but rather argues that the Second Circuit failed to take into

account the past dealings of Richardson (E&H's customer) with E&H, including Richardson's history of late deliveries, as required by *Naftalin* (P., pp. 10-11). This is simply not so. The Second Circuit stated:

> "Its [E&H's] sporadic inquiries of the clearing agent [WFSCC] were not legally sufficient in the circumstances, considering the size of the 'fails,' the history of the dealings with Richardson, and the omission to observe the requirements of even a relaxed interpretation of Regulation T and of the Commission's rules. Moreover, if there was an intervening efficient cause for its loss, it was its reliance on the responses of Richardson itself to sporadic inquiries. These responses were evasive, and E&H had no right to rely on them unless they afforded a 'credible' reason for the delay in delivery of the securities. See *Naftalin & Co. v. Merrill Lynch, supra,* 469 F.2d at 1177 & n.14. Since the transactions were effected directly between broker-dealer (E&H) and broker-dealer (Richardson), it is quite inexplicable that credible explanations for late delivery should not have been demanded of Richardson itself. This failure to press Richardson for the specific reasons for the particular delays and whether the purported long sales were not, in fact, short sales, can only be attributed to E&H's desire for commissions and its willingness to extend credit, if necessary, in the cash account." (P.A., p. 19a)

E&H appears to be arguing (P., pp. 9-13), as it did to the Second Circuit, that as long as it reasonably believed that securities sold by Richardson would be delivered *at some time,* it did not violate Regulation T. E&H totally misses the point of its Regulation T obligation. Regulation T requires not only a good faith belief that securities will be delivered, but also a good faith belief that such securities are owned by the customer and that delivery will be made promptly. Both requirements are found in Section 4(c)(1)(ii) of Regulation T,[1] and the *Naftalin* result turned upon the existence of the good faith belief and the meaning of the word "promptly" in relation to the actions of the claimant broker/dealers (469 F.2d at 1176-1177).

Success for E&H in this case would be dependent upon this Court importing into Regulation T the concept that, because of an alleged but unproved industry practice of ignoring Regulation T when the customer is a third market firm, a broker/dealer need not have (i) a good faith belief that the security is owned by the customer, or (ii) an agreement with the customer that the security will be delivered promptly, until some point after three weeks from the settlement date. Such a concept would be in conflict with the basic purposes of Regulation T. *See Pearlstein v. Scudder & German,* 429 F.2d 1136 (2nd Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971).

To accept E&H's argument that the Second Circuit's decision inhibits or impedes market efficiencies (P., pp. 12-13) is to accept the argument that applicable law does so.

In concluding its first argument (P., p. 13), E&H states that it is "essential that this Court determine the appropriate standards required by Regulation T." It is difficult to see why it is "essential" since (i) the requirements of Regulation T in this regard are specific, (ii) lower courts have uniformly defined a broker/dealer's duties under Regu-

---

1 Section 4(c)(1)(ii) of Regulation T, 12 C.F.R. § 220.4(c)(1)(ii), reads as follows:

> "In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may: . . . (ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be *promptly* deposited in the account." (Emphasis added.)

lation T concerning sales in a cash account, and (iii) the Second Circuit's decision in this case is in accord with the express requirements of Regulation T and the court decisions with respect thereto.

II

THE SECOND CIRCUIT'S DECISION IS NOT IN CONFLICT WITH DECISIONS OF OTHER COURTS OF APPEALS OR BASED UPON UNSETTLED LEGAL PRINCIPLES.

A. The Second Circuit Did Not Rule, As Claimed By E&H, That A Broker/Dealer's Negligence Or Violation Of Regulation T Is A Complete Bar To The Recovery Of Damages By Such Broker/Dealer. The Second Circuit Ruled That Where A Broker/Dealer's Own Conscious Acts, Careless Indifference And Lack Of Due Diligence (Including Regulation T Violations) Caused Its Own Loss, It May Not Recover Damages From WFSCC On Secondary Liability Theories.

E&H's claim (P., pp. 13-16) that the Second Circuit ruled that negligence *or* a Regulation T violation is a complete defense to a securities fraud action misconstrues the Second Circuit's opinion. The Second Circuit held that based upon all the facts and circumstances of this case, E&H (a broker/dealer) may not recover damages from WFSCC (on secondary liability theories) where E&H's own conscious acts, careless indifference and lack of due diligence caused its own loss (P.A., pp. 16a-25a, 27a). The Second Circuit pointed to numerous factors in so holding, including, among others, (i) "E&H's desire for commissions and its willingness to extend credit" (P.A., p. 19a); (ii) "its careless attitude in marking the Richardson sales 'long' " (P.A., p. 18a); and (iii) its conscious assumption of the market risk (P.A., p. 21a).

B. E&H's Attempt To Classify Its Actions As Merely Constituting Negligence Is Not In Accord With The Second Circuit's Opinion And Applicable Law.

E&H attempts to imply (P., pp. 13-16) that its actions merely constituted negligence. The Second Circuit in this case did not so hold. The Second Circuit characterized E&H's actions utilizing the following terms: (i) "careless attitude" (P.A., p. 18a); (ii) "desire for commissions and willingness to extend credit" (P.A., p. 18a); (iii) "Edwards consciously assumed a market risk for E&H" (P.A. 21a); and (iv) "indolence and folly, or a careless indifference to the ordinary and accessible means of information" (P.A., p. 25a).

E&H also assumes that the Second Circuit found the violation of Regulation T (and thus Section 7 of the Securities Exchange Act of 1934, the "Exchange Act") to be the equivalent of a negligence finding. Even forgetting the Second Circuit's description of the violation as a "conscious" violation (P.A., p. 21a), the Second Circuit's finding of a Regulation T violation based principally upon a failure to investigate constitutes a finding of willfulness. "Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term "willful" in the Exchange Act.' " *Hanly v. SEC,* 415 F.2d 589, 595-596 (2nd Cir. 1969); *Dlugash v. SEC,* 373 F.2d 107, 109 (2nd Cir. 1967); *Quinn & Co. v. SEC,* 452 F.2d 943, 947 (10th Cir. 1971), *cert. denied,* 406 U.S. 957 (1972).

C. The Second Circuit's Decision In This Case Is Not In Conflict With The Decisions Of Other Circuits.

E&H claims a conflict between the decision of the Second Circuit in this case and rulings in the Fifth, Seventh and Tenth Circuits, citing *Dupuy v. Dupuy,* 551 F.2d 1005 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1977), *Sundstrand*

Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977), and *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (P., p. 14). These cases do not rule out the concept that a plaintiff's conduct may constitute a bar to recovery but rather speak of the type of conduct of the plaintiff which will defeat recovery. The *Dupuy* decision speaks of the required conduct as "due diligence," measured by a reckless standard in cases where the defendant is guilty of scienter (*Dupuy, supra*, 551 F.2d at 1023). The *Holdsworth* and *Sundstrand* decisions speak in terms of plaintiff's conduct which constitutes "contributory fault . . . gross conduct comparable to that of defendant," and in terms of plaintiff's conduct which results in a failure to establish justifiable reliance and hence causation (*Holdsworth, supra*, 545 F.2d at 693-694; *Sundstrand, supra*, 553 F.2d at 1048). All three decisions state that recklessness or intentional conduct of the plaintiff (even a non-broker/dealer plaintiff) serves as a defense to a Section 10(b) and Rule 10b-5 fraud action where the defendant's conduct involves scienter (*Dupuy, supra*, 551 F.2d at 1020; *Sundstrand, supra*, 553 F.2d at 1048; *Holdsworth, supra*, 545 F.2d at 693).

The Court of Appeals in this case quoted from *Hirsch v. du Pont*, 553 F.2d 750, 763 (2nd Cir. 1977), the proposition that "the securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment" (P.A., p. 17a). In this case as in *Hirsch*, the plaintiff was a broker/dealer and the defendant was found to have no fiduciary or quasi-fiduciary duty to the plaintiff. All three cases cited by E&H, *Dupuy, Sundstrand* and *Holdsworth*, involve non-broker/dealer plaintiffs to whom the defendant, an alleged primary violator, owed a fiduciary or quasi-fiduciary duty.

WFSCC respectfully submits that even if E&H's actions merely constituted negligence, the Second Circuit's opinion in this case would not create a conflict with decisions of other Circuits that would require resolution by this Court.

The Fifth, Seventh and Tenth Circuits in *Dupuy, Sundstrand* and *Holdsworth* held that, in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the plaintiff's negligence does not bar such plaintiff from recovery when the defendant's liability is predicated on a finding of scienter. These cases recognize that where the defendant's liability is predicated on negligence, negligence of the plaintiff in failing to exercise due diligence will bar plaintiff's recovery. In this case the District Court found that liability could be imposed on WFSCC only vicariously based either upon the failure by WFSCC as a control person to adequately supervise Werba under Section 20(a) of the Exchange Act or upon agency principles (P.A., pp. 56a-58a). The Court of Appeals concurred that if liability existed at all, it would exist on those theories (P.A., p. 15a). The Fifth, Seventh and Tenth Circuits have not decided what standard of conduct would be imposed on a plaintiff seeking damages from a defendant on those theories.

WFSCC respectfully submits that if the Fifth, Seventh and Tenth Circuits were to be presented with a case of the nature of this case or *Hirsch v. du Pont, supra*, those Circuits would rule with the Second Circuit and deny the recovery of damages, particularly in light of the special and stringent duties placed upon broker/dealers by the federal securities laws. *See e.g., Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38 (2nd Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Zweig v. Hearst Corporation*, 521 F.2d 1129, 1135 (9th Cir. 1975), *cert. denied*, 423 U.S. 1025 (1975).

E&H's claimed conflict among the circuits is non-existent.

D. This Case Does Not Raise The Question Whether An Investor Has A Private Cause Of Action For Damages Againgst A Broker/Dealer For A Violation Of Regulation T.

The circuit court cases referenced by E&H (P., p. 15), concerning whether an investor has a private cause of action for damages against a broker/dealer for violation of Regulation T in light of the enactment of Exchange Act § 7(f) and Regulation X, have no applicability to this case. This case does not involve the "offensive" use of a Regulation T violation by an investor who is also a margin rule violator; instead, it involves the "defensive" use of a Regulation T violation by a non-margin rule violator as one of the reasons for denying the award of damages to the violating broker/dealer. Even if an investor does not have a private right of action for margin rule violations, that does not mean that such violations cannot serve as a defense, either on the theory that violation by plaintiff is itself a defense (as held by *Naftalin* and *Grimes, Hooper*) or that it is evidence that the plaintiff broker/dealer's loss was caused by its own willfulness, recklessness and lack of due diligence.

This should particularly be the case where, as in this case, a broker/dealer Regulation T violator (E&H) is suing a non-violator of the margin regulations (WFSCC) on secondary liability theories. Broker/dealers have full responsibility for complying with Regulation T (*Naftalin*, 469 F.2d at 1181). and there is no legitimate basis for imputing Richardson's Regulation X violation to WFSCC, particularly since WFSCC had no control over Richardson.

To say that WFSCC cannot raise Regulation T as a defense is to say that no defendant can raise a violation of

the securities laws by a plaintiff as a defense to the recovery of damages. That result would not encourage compliance with the securities laws.

III

THE COURT OF APPEALS EXERCISED PROPER APPELLATE PROCEDURE AND THE RECORD SUPPORTS ITS DECISION.

E&H's challenge to the facts relied upon in the decision of the Court of Appeals will not withstand scrutiny if the record is brought before this Court.

E&H's first and presumably most important claim is that there is no support in the record for the proposition that "E&H delivered stock of its own customers or other brokers to cover the Richardson fails by either borrowing the stock or using stock in the house" (P., p. 16). In the District Court, Arthur M. Foote, Jr., head cashier of E&H, testified that on a failed delivery by Richardson of Halliburton stock, he was fairly certain that E&H had closed out the street side by netting the stock out by a subsequent purchase of another customer, by using stock in customers' margin accounts or by borrowing stock from firm accounts, although he didn't know which (Joint Appendix in the Court of Appeals ("J.A."), pp. 597-598). He also testified that in the beginning of April, 1975, E&H had pressure from the street on stock sold by Richardson because E&H was no longer a major retail house. It was his practice to check the availability of the box, bank loans, and borrowing "wherever I could get the stock, if I were making delivery, if I had pressure from the street" (J.A., pp. 598-599).

In further stating that no authority was cited by the Court of Appeals that such conduct violated any law, E&H ignores the citation by the Court of Appeals to Rule 10a-2(a) under the Exchange Act which is set forth in full

in E&H's Petition (P.A., p. 95a). That Rule is clearly violated by such arranging for borrowing under the circumstances presented in this case.

As to E&H's second point (that the Court of Appeals erroneously assumed Richardson could have engaged in legitimate short sales — P., p. 17), E&H knew that Richardson was a third market firm acting as principal with matching buyers and sellers being its primary business. (J.A., p. 418). There is no evidence in the record to support the conclusion that Richardson could not engage in legitimate short sales. In fact Richardson could do so if it made a sale in anticipation of making a purchase involving excess stock or if it made a short sale unrelated to its primary business. E&H's duty of inquiry should have been ever present.

The third and fourth points discussed in E&H's Petition (whether deliveries were inordinately late and whether E&H's reliance on Richardson's responses was reasonable in light of the partial deliveries made — P., p. 17) clearly involve questions of the appropriate interpretation of the facts in light of the legal duties imposed upon E&H, rather than a resolution of the underlying facts. E&H fails to distinguish between appellate fact finding, which the Court of Appeals did not engage in, and the application of the law to those facts, which is the province of the Court of Appeals. The application of a legal standard to the facts is not a finding of fact within Rule 52(a). *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1200 n. 3 (2nd Cir. 1978); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 15 (2nd Cir. 1977); *In re Hygrade Envelope Corp.*, 366 F.2d 584, 588 (2nd Cir. 1966).

With respect to the fifth point (wrongful attribution of negligence to E&H based in part on the fact that other brokers ceased doing business with Richardson — P., pp.

17-18), there is clearly no appellate fact finding involved. The Court of Appeals merely repeated (and quoted from) the decision of the District Court below: "Beginning as early as February 1975, Richardson's bigger brokers, E. F. Hutton, B. C. Christopher and North American Equity (as well as Kaufman & Co.) informed Richardson that they were buying in their accounts with Richardson and would no longer do any business with it 'because of its consistently late deliveries of stock that it had sold to them.' 458 F.Supp. at 1117." (P.A., p. 7a)

The Court of Appeals properly treated the issues before it as mixed questions of law and fact as to which it was not bound by Rule 52(a). *Mamiye Bros. v. Barber Steamship Lines, Inc.*, 360 F.2d 774, 776-78 (2nd Cir. 1966), *cert. denied*, 385 U.S. 835 (1966). A fair reading of the decision would also lead to the conclusion that the Court of Appeals was "left with the definite and firm conviction that a mistake has been committed," thus justifying a reversal within the test set forth in *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

CONCLUSION

No amount of strained argument can convert this case into one warranting review by this Court. The Second Circuit's decision below turned on its own facts and, insofar as the issues raised by E&H's Petition are concerned, affects no one but the parties to this case. Moreover, independent grounds cited by Second Circuit, not challenged by E&H, indicate that this case was correctly decided.

There is no conflict of decisions among the Circuits. There is no important question for this Court to review. There is no need for this Court to exercise its supervisory powers.

For the foregoing reasons, it is respectfully submitted that E&H's Petition for a Writ of Certiorari should be denied.

Dated: December 21, 1979.

Respectfully submitted,

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